S. HRG. 104–509

NOMINATIONS OF: ALAN GREENSPAN, ALICE M. RIVLIN AND LAURENCE H. MEYER

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BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

ON

NOMINATIONS OF:

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ALICE M. RIVLIN, OF PENNSYLVANIA, TO BE A GOVERNOR AND SERVE AS VICE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, VICE ALAN S. BLINDER, RESIGNED

LAURENCE H. MEYER, OF MISSOURI, TO BE A GOVERNOR OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM VICE JOHN P. LAWARE, RESIGNED

MARCH 26, 1996

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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TUESDAY, MARCH 26, 1996

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 11:10 a.m., in room 538 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN ALFONSE M. D'AMATO

The CHAIRMAN. Good morning.

The Committee is privileged today to have three very distinguished nominees for the Board of Governors of the Federal Reserve System.

The Committee will consider the nominations of: Alan Greenspan, renominated to serve a third term as Chairman of the Federal Reserve; Alice Rivlin and Laurence Meyer, both to be Fed Governors. Dr. Rivlin is also nominated to serve as the Vice Chairperson.

Chairman Greenspan will be joining us at the conclusion of the Federal Open Market Committee meeting, and we believe that will be about 12 o'clock. If confirmed, at the conclusion of his term, he will have served as Chairman for over a decade. His wisdom and experience have helped to avert several global financial crises. In

fact, Alan Greenspan is properly known as the world's preeminent central banker. With this impressive track record, President Clinton's renomination of Chairman Greenspan is well deserved.

Dr. Alice Rivlin, the President's nominee for Vice Chairmanship, became the Director of the President's Office of Management and Budget in October 1994 after having served as OMB's Deputy Director for over a year. Dr. Rivlin has shown her willingness to focus on tough choices in the context of deficit reduction amidst sometimes very strong political pressure, to say the least. Dr. Rivlin is perhaps best known as the first Director of the Congressional Budget Office, serving from 1975 to 1983.

Our final nominee, Dr. Laurence Meyer, is well known to the business and economic community for his award-winning work in macroeconomic forecasting and policy analysis. Dr. Meyer is President of Laurence H. Meyer and Associates, a highly regarded macroeconomic consulting firm in St. Louis, MO. His firm's impressive list of clients includes key agencies of the U.S. Government, major trade associations, and private corporations.

The Committee anticipates acting expeditiously on these nominees in order to ensure full representation at the Board of Governors of the Federal Reserve. We look forward to hearing their remarks and thoughtful discussions of the important economic issues facing this country.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, thank you very much. I am very pleased to welcome Dr. Alice Rivlin and Larry Meyer before the Committee.

Let me just say a few words about Alice Rivlin, whom I've known for quite some time. I think extremely highly of this nomination. Alice Rivlin has had a very distinguished career. She, of course, was an honor graduate of Bryn Mawr College, has a Ph.D. from Radcliff and was for many years at the Brookings Institution where she at one point was the Director of the Economic Studies Program. She participated in that program for a number of years. She served in the Department of Health, Education, and Welfare as an Assistant Secretary for planning in the late 1960's.

In 1975, as we all know, she became the first Director of the Congressional Budget Office and served there until 1983, in other words, for 8 years. During that period, I think largely due to her very skillful and strong leadership, the CBO developed a reputation for independent professional analysis of controversial issues that stays with it even today. That's no small achievement, to take a new institution and to build to that high standard in that period of time.

Subsequently she was a McArthur Foundation Prize Fellow, a high distinguished award, and of course she came back into Government in 1993 as a Deputy Director of the Office of Management and Budget, and then became the Director of the Office of Management and Budget in October 1994, a position she presently holds.

Both her record at CBO and at OMB have been exemplary. At OMB, of course, she developed policies that I think contributed significantly to the effective performance of the economy. She has

maintained the highest standards there as she did at CBO and I think both are a very significant achievement.

She is a frequent author, as we know, of magazines, journals, and books. But I think most importantly she brings expertise and experience to the Federal Reserve and a wide range of public policy positions. Her peers among professional economists have recognized her exceptional talents over the years, in fact choosing her as President of the American Economic Association. I'm convinced that the Federal Reserve and the Nation will benefit from her skills as an economist, as a policy analyst, and as an institutional builder, and I really commend the President for this nomination, and of course recommend her very strongly to my colleagues.

Let me just say a word about Larry Meyer, whom I don't know as well personally, but who has an extraordinary reputation within the economics profession and is considered as perhaps our Nation's most preeminent economic forecaster.

He is a graduate of Yale and then got a Ph.D. from MIT. He has been at Washington University in St. Louis now for a number of years, I think since the early 1970's, if I'm not mistaken. He heads up his own economic forecasting firm which has won the Blue Chip Economic Forecast Award for the most accurate forecasts both in 1993 and in 1995. I gather he didn't get it in 1994 because they don't give it 2 years in a row, or otherwise I think he would have had it then as well.

So he is going to be a very important and significant addition to the Federal Reserve Board, and I'm pleased to welcome him before the Committee.

Thank you.

The CHAIRMAN. I'm going to recognize Senator Bond for the purpose of introducing one of the nominees.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman.

I do apologize to the witnesses and my colleagues. I have another commitment that I am going to have to make this morning, but I do want to join you in welcoming Dr. Meyer and Dr. Rivlin. We are very honored to have two such highly qualified individuals with us today.

I am particularly pleased, Mr. Chairman, to introduce a fellow Missourian, Dr. Laurence Meyer for nomination to the Federal Reserve Board of Governors. With more than 27 years of experience in academics, consulting and economic forecasting, Dr. Meyer has long been a leading figure in national economic forecasting and development, and I believe that his background in the public, private, and academic centers make him uniquely qualified for this position on the Federal Reserve Board.

In my home State of Missouri, Dr. Meyer has played a key role in the development and expansion of the Economics Department of Washington University. As former department chairman and a university professor, Dr. Meyer has been recognized repeatedly for his academic achievements by students and faculty alike.

Fellow economists similarly appreciate his expertise having twice granted him the prestigious Annual Forecast Award for being the

most accurate forecaster on the panel for the Blue Chip Economic Indicators.

As an adviser to each of the last three Presidents, Dr. Meyer has demonstrated an ability that is unique in Washington, the capacity to rise above partisan politics. Even today Dr. Meyer counts among his clients the President's Council of Economic Advisers, the Office of OMB, and the Departments of Treasury and Commerce.

To balance this perspective I might tell my colleagues here that Dr. Meyer also advises our House colleague and Budget Committee Chairman, John Kasich on budget-related issues. I do not know whether that should have been on the public record, but I'm willing to take a chance on that.

The CHAIRMAN. Do you think the President was aware of this? [Laughter.]

Senator BOND. If you won't tell him, Mr. Chairman, I won't.

Finally, Dr. Meyer also represents the entrepreneurial spirit in all Americans. Almost 15 years ago this university professor and two former students invented the first macroeconomic model that could be programmed into a personal computer. Today his business sells models and forecasts to major corporations and governmental agencies across the Nation and, as we have heard previously, the thing must work because he has been remarkably successful in his forecasts.

I have also heard from his colleagues at Washington University with whom he has had spirited political discussions that while they feel that he may be wrong-headed occasionally in political choices, that his economic credentials are very solid and they give him the strongest recommendations on the basis of qualifications.

In conclusion, Mr. Chairman, I think that Dr. Meyer's unique experience in the public, private, and academic areas will prove invaluable as we move into the 21st century.

Mr. Chairman, I am pleased to endorse the nomination of Alice Rivlin to be Vice Chairman. As the Director of OMB she demonstrated the requisite leadership abilities and the economic acumen necessary to lead our country in the next century. I think her extensive Federal Government experience with strong academic qualifications and private sector expertise will be valuable in her new role, and I would strongly support her nomination.

Finally, though he has not yet joined us this morning, I want to offer my wholehearted endorsement for Chairman Greenspan for his third term as Chairman. Under his adept leadership, the U.S. economy has achieved an unprecedented level of economic stability. As an ardent apostle of free markets Chairman Greenspan also understands the curious world of Washington politics. These unique qualities together with his understanding of economic theory make Chairman Greenspan uniquely qualified for a third term as Federal Reserve Board Chairman.

Thank you, Mr. Chairman, and I thank my colleagues.

The CHAIRMAN. Thank you, Senator.

Senator Domenici for the purposes of an introduction.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman and fellow Senators.

I think I could do best by Dr. Rivlin by being extremely brief because all of you are waiting around to do the questioning and do our job as a Committee. When Dr. Rivlin called and asked me if I would introduce her I didn't hesitate a minute. I said of course, and I'm pleased to be here doing that.

I first met Dr. Rivlin when we were talking about creating the Congressional Budget Office and getting it started. That is a long time ago, 1975. I don't think there are very many examples, Mr. Chairman, and fellow Senators, of a major institution created by the Congress of the United States that has as one of its objectives nonpartisan, nonpolitical evaluation of the facts, fiscal facts of the Nation. That's what CBO was supposed to do.

I think it is fair to say that CBO has achieved that goal. We believe they are better and more fair and more reasonable and more impartial than any other group doing economics for Government. In fact to be honest, we choose CBO over the OMB which she now heads. I regret to say that, but I believe we do. I think a lot of that is because she was a great leader and could understand the importance of giving Congress impartial, valid information about the budget of our country and the problems with programs.

She has been an unabashed fighter for deficit reduction. She has been unabashed about calling it like it is. She has not always been successful in getting it done, but she has called to our attention that entitlements must be curtailed or sooner or later the American Government will have no money to spend anywhere else.

She has a great economic background, and economists think she is a very good economist. She has been the president of their organization nationally, and you can't ask for much more.

Then she has great ideas. She wrote a book before she took this job, and while she didn't agree with the Republican way of changing Federal Government and sending it down to local government, she talked about saving America and saving the dream by refocusing where Government should be with a lot more emphasis on local governments doing certain things and the Federal Government doing less but doing them better.

That does not mean she is only for change. She understands in a capitalist economy there are some rather perpetual ingredients, and I am confident that on this Federal Reserve Board as a collegial member she will do everything she can to maintain a strong economy and at the same time to keep inflation under control, and I wholeheartedly recommend her and thank her for asking me to introduce her.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Gramm.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, let me say that I think in the past some may have challenged the President's nominees for various positions. I have voted against relatively few feeling that within board limits the President has the right to appoint his own people and that elections have consequences.

But I would say in the three nominees that are before us today that the President has certainly strengthened his record. These are

all people that deserve to be confirmed. There is nothing controversial about any one of them. Each and every one is totally qualified for the position that they've been appointed. In an era when we often don't have very much good to say about the President for a very good reason, there is not very much good to say about the President, I think it is important to note that these are three excellent nominees. I intend to vote for all of them, and I think the President has shown good judgment in their nominations.

The CHAIRMAN. Thank you, Senator.

Senator Shelby.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you. Mr. Chairman, I ask that my written statement be made part of the record in its entirety.

The CHAIRMAN. So ordered.

Senator SHELBY. I will be brief. I join with the others in welcoming you to the Banking Committee, both of you, and a little later on the Chairman, Mr. Greenspan. I believe that the President has shown a lot of wisdom in nominating Alan Greenspan again, you, Dr. Rivlin, and also Dr. Meyer. I look forward to hearing from you. There are going to be a lot of questions here. We want to get into, Dr. Meyer, some of your economic forecasting and see where we are going.

Thank you.

The CHAIRMAN. Senator Mack.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I simply join in—oh, I'm sorry.

The CHAIRMAN. Well, Senator Bennett, since you've started why don't you go ahead?

Senator BENNETT. I guess I have Faircloth's disease. I heard Bennett instead of Mack. I had better get my ears cleaned out. I apologize.

[Laughter.]

Senator MACK. Go ahead.

The CHAIRMAN. Senator, why don't you continue?

Senator BENNETT. Well, there's really nothing to continue other than I'm joining with my colleagues in welcoming these three nominees and signaling my intent to vote in favor of them, and I yield to Senator Mack.

The CHAIRMAN. Senator Mack.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman, and thank you, Senator Bennett.

I, too, want to welcome both nominees and Chairman Greenspan when he arrives. I support the comments that have been made here this morning. Certainly I intend to support the nominees for this position. I do have a few comments I would like to make at this point.

In my opinion, the Federal Reserve has an important role to play in our economy, and I am confident that the nominees coming in front of this Committee today will take that role seriously. I gather

that not only from their personal backgrounds, but appreciated the opportunity to talk with both of you when you came by my office over the last few days.

The Federal Reserve can only accomplish one long-term objective, protecting the value of our money. The Federal Reserve has the power to do a great deal of damage, however, and if the Fed adds too much money to the economy inflation is the result and our currency falls in value.

In the late 1970's when monetary authorities attempted to boost growth, my constituents in Florida, and I know everyone throughout the country, saw one third of their savings eroded by inflation in 3 years.

To add just another perspective to that, one of the things special about the State of Florida is we have a tremendous number of retirees who worked and saved their entire lives setting aside resources for their retirement years. Think about the shock that it must have been to them in the late 1970's and early 1980's—as they saw one third of everything they had worked for their entire lives to save and set aside, once they could no longer work. One third of it was gone in 3 years, and I don't think that should happen again.

In recent years the Federal Reserve has managed its duties well. Under Chairman Greenspan, who was appointed in August 1987, the price of gold was $461 per ounce, and 30-year Treasury bond yields were almost 9 percent. Today gold prices are down to around $400 an ounce, and 30-year Treasuries are near 6.5 percent. In my view the reason gold prices and bond yields are down is because inflationary expectations are down. For the past 5 years a well-conducted monetary policy has kept inflation below 3 percent. This is an extraordinary record given our experience during the two decades before then.

The numbers speak for themselves, and many Americans have benefited. With mortgage rates down many people have purchased their first home and even more have refinanced at lower rates. Low inflation has boosted the value of pension funds and retirement assets. Americans are benefiting from a Federal Reserve concerned about inflation. This record must stay intact.

Nonetheless in recent months with signs of weakness in the economy it has become commonplace to blame the Federal Reserve for slow growth. The President and other critics of the Federal Reserve Board refuse to look at the impact of fiscal policy on economic growth. Increases in taxes, regulation in Government burdens during President Clinton's Administration have slowed the potential growth in the economy.

Let's set the facts straight on growth. I will stand second to no one in my support of policies which enhance economic growth. Economic growth does not come from appointing easy money advocates to the Fed. If it did, counterfeiting would be legal. Real growth comes from entrepreneurial activities, savings, and investment. The way to increase these activities is to free the economy from the handcuffs of Government. We must cut taxes, reduce spending, and slash regulation.

For these reasons I've introduced the Economic Growth and Price Stability Act. This bill is designed to minimize inflation and there-

by maximize economic growth. The Federal Reserve can best maximize economic growth by keeping prices stable. Any attempt to use the Federal Reserve to boost growth always results in higher interest rates, more inflation, less employment, and slower growth over the long run.

I hope all the nominees understand this, and I'm looking forward to their testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Faircloth.

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman.

I am very pleased to be here and I am in strong support of Mr. Greenspan's reappointment as Chairman of the Federal Reserve Board. Although he won't be here until 12, let me just say this about his tenure.

The Fed has been marked by an enormous stability in our economy. Since 1991 inflation has not been above 3 percent. Since he was first appointed in 1987 only once has inflation exceeded 5 percent. That is a record of reliability, and it is one the American people have greatly benefited from.

I want to say to the other two nominees, Ms. Rivlin and Mr. Meyer, while I am prepared very much to support your nominations, that I hope you will follow the lead of Mr. Greenspan. The Congress can appropriate money, but the Federal Reserve has the power to create money, and this is an awful responsibility and we should never take it lightly. Further, it seems that that is the line of demarcation that separates our economy from other nations such as Mexico, the fact that we have a strong independent Central Bank not subject to the short-term political needs and whims, and I hope that we will forever keep it that way.

Finally, some in the Congress have suggested that the Federal Reserve should be an engine of growth, that the Fed can stimulate growth without risking inflation, but that is not the issue. If anybody can stimulate growth, it's the Congress. We need to regulate less, we need to stop borrowing $850 million a day that we don't have, we simplify the Tax Code, and these are the things we need to be doing to stimulate real growth and basic growth.

With that, Mr. Chairman, let me wish Ms. Rivlin and Mr. Meyer well in their soon-to-be new positions.

The CHAIRMAN. Thank you, Senator.

Senator Boxer.

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Thanks, Mr. Chairman.

Congratulations to both of you and to President Clinton who has made three very solid nominations here, and I feel very good about your prospects from what I've heard from my colleagues.

I want to agree with Senator Mack that inflation is key, that the rate of inflation is key to economic prosperity and we must always keep our eye on that, but I certainly want to say that equally important to this particular Senator is the rate of growth and the ability of our people to feel confident in their future. You know, I'm one of these people who thinks that in this case when you have

such talented people at the Fed you can look at both, you can walk that fine line, and you can walk and chew gum at the same time, if you will.

I think we are picking people and selecting people who don't need to be told by U.S. Senators how to do that. I have faith in Mr. Greenspan, and I have faith in you. Frankly, I think it is healthy if people come to the table with slightly different viewpoints, and I certainly think we don't want to have one person dictate a policy, be it one of you two or the Chairman.

I think it's important that these things be discussed, and just to put it on the table I think it has now become very fashionable for politicians to talk about anxiety in the workplace, and we are hearing it from Republican candidates for President, we are hearing it from Democratic candidates for President, and we are hearing it from very mainstream candidates in both parties. I for one am glad because there are things that lead to insecurity and I don't think that they're all that removed from what you do because what you do will have a definite impact as to whether the economy expands jobs or contracts jobs. That is a very difficult choice that you are going to be faced with, but I hope you will in fact keep both of those goals always—always in your mind.

Right now we are in a situation where we are in a global marketplace and there are different factors. When I went to school and majored in economics it was a different world. The kids I hung around with their dads got gold watches. They were going to get the gold watches after 30 years at a job. It was a very secure kind of world. It's a global marketplace and it's different, as the President has said many times. We are facing competition from other countries that have cheap labor.

We don't have guaranteed health care in this country, and I hope we're going to fix some of that in a bipartisan effort to allow people to take health care with them. There are raids on pensions, and I hope we can protect those pensions, and there is a need for constant worker retraining. All those things are not going to be in your domain, but economic growth I think is in your domain.

So I just would say perhaps as a counterbalance, surprise, surprise, that I think both of these factors, keeping inflation low, and we all know what happens to other countries when inflation rates get out of control, and it has happened in this country, and I lived through it. Senator Mack is right, it is a terrible tax on our people. Inflation is a terrible tax, and particularly on those who are retired. It is a horror story. But that does not mean we have to close our eyes to the rest of the economy. We have to look at it all. So that is my message.

I wish you every good wish, and thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Murray.

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Mr. Chairman, I will pass on an opening statement, and just let me join my colleagues in welcoming both of you and I look forward to supporting your nominations through this process.

I would just say one thing and remind you when you are sitting on that Board and looking at interest rates that it does affect every one of our constituents, and although they feel very disconnected from a lot of what happens here, certainly interest rates have a tremendous impact on their personal lives.

I appreciate both of you for your willingness to go through this process and for being willing to serve.

Thank you.

The CHAIRMAN. Would you both please stand for the purposes of the oath.

[Whereupon, Alice Mitchell Rivlin and Laurence Harvey Meyer stood and were duly sworn by the Committee Chairman as follows:]

The CHAIRMAN. Do you swear or affirm that the testimony you are about to give is the truth, the whole truth and nothing but the truth, so help you God?

Ms. RIVLIN. I do.

Mr. MEYER. I do.

The CHAIRMAN. Do you agree to appear and testify before any duly constituted Committee of the Senate?

Ms. RIVLIN. I do.

Mr. MEYER. I do.

The CHAIRMAN. Thank you very much.

Ms. Rivlin, we would be pleased to receive your statement.

OPENING STATEMENT OF ALICE M. RIVLIN OF PENNSYLVANIA, TO BE A GOVERNOR AND SERVE AS VICE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. RIVLIN. Thank you, Mr. Chairman.

I am pleased and honored that the President has nominated me to serve as Vice Chair and member of the Board of Governors of the Federal Reserve System. Presuming that the Committee and the rest of the Senate approve my nomination, I look forward to serving in those important posts.

This is, indeed, a particularly challenging time to help set the Nation's monetary and banking policy. The American economy is changing rapidly and becoming increasingly interlinked with the rest of the world. At the same time, the structure and technology of banking and financial services industries—at home and abroad—are making the transition to a future whose outlines are still far from clear.

For most of my career as an economist, I have been primarily concerned with fiscal policy, budget choices, and the management of Federal spending programs. I have been a strong advocate of fiscal responsibility and of budget choices designed to enhance the long-run growth of the American economy and a rising standard of living for average Americans. Working on fiscal policy has made me acutely aware of the importance of sensible, soundly-based monetary policy and of a strong banking system to the present and to the future health of the American economy. I am delighted at the prospect of shifting focus to policies under the aegis of the Federal Reserve.

At the moment, the economy, at least at the aggregate level, is performing extremely well. Unemployment is lower than many

economists would have thought possible without igniting inflation, and yet inflation is not visibly accelerating.

The budget deficit has been cut in half in the last 3 years, and there is good hope of reaching a balanced budget.

The challenge now, both for monetary and fiscal policy, is to keep up the good work and find the continuing set of policies that will enable the U.S. economy to attain maximum sustainable growth as we move into the 21st century.

I have great respect for Chairman Alan Greenspan, whom I have know for a great many years, and for other members of the Board of Governors, and for my fellow nominee, Larry Meyer. I expect the Board and the Open Market Committee to involve lively exchanges of ideas, in which I will not hesitate to make my own views clear.

I look forward to a close working relationship with the Chairman and other members of the Board, as well as frequent communication with this Committee and with other Committees of the Congress.

Mr. Chairman and Members of the Committee, I would be delighted to address your questions.

The CHAIRMAN. Thank you very much.

Mr. Meyer.

OPENING STATEMENT OF LAURENCE H. MEYER OF MISSOURI, TO BE A GOVERNOR OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MEYER. Thank you, Mr. Chairman and Members of the Committee. It is a pleasure for me to appear before you today as President Clinton's nominee to serve on the Board of Governors of the Federal Reserve System.

I pledge, if confirmed, to work with the other members of the Board to carry out the objectives that you, the Congress, have established for monetary policy and the responsibilities you have entrusted to the Federal Reserve with regard to protecting the safety and soundness of the banking system, ensuring the efficiency and integrity of the payments process, and enforcing fair lending laws and other consumer legislation. These are wide-ranging and important responsibilities and I look forward to the opportunity to serve the Nation in their pursuit.

Let me turn now directly to my views on the role of monetary policy.

Economists usually identify three objectives as central to excellent macroeconomic performance. These objectives are price stability, full employment, and adequate growth. I want to address the role of monetary policy in relation to each objective. I have chosen an ordering of the objectives that reflects the degree of control and therefore responsibility the Federal Reserve has over each. One of the themes I want to develop is that you should never expect more of a policy than it can deliver.

Price stability comes first because it is a singular goal for monetary policy in the long run. Macroeconomic theory tells us that, in the long run, inflation is principally caused by money supply growth which in turn is determined by the Federal Reserve System. When it comes to price stability, therefore, the buck literally stops at the Federal Reserve.

The second goal, full employment, is the basis for the commitment in the Federal Reserve Act to "maximum employment." The language of the Act leaves much to be desired from the standpoint of precision. If we accept that "maximum employment" can be translated into achieving and maintaining "full employment," then "all" we have to do is to define full employment. The conventional wisdom, which I fully endorse, holds that full employment is the maximum level of employment that can be sustained without suffering increasing inflation.

This view implies that there is no long-run tradeoff between inflation and unemployment. Therefore, there is no conflict in the long run between the objectives of price stability and full employment. While the Federal Reserve cannot fine-tune the economy, it can and it should, in my judgment, make efforts to smooth out the business cycle.

The third goal, adequate economic growth, has certainly gotten its fair share of attention of late. As you know, the President has focused considerable attention on this goal, and appropriately so, in light of the disappointing rate of growth in real GDP on average since the early 1970's and stagnation in real spendable income by the median family over the past 20 years.

Before I present my views on the role of monetary policy with respect to growth, let me clarify this goal and distinguish it from that of full employment. By growth, I mean the growth in the economy's productive capacity: That is the rate of growth possible once the economy achieves full employment. I will refer to this as "trend growth." Trend growth is a result of growth in the labor force, growth in the capital stock, and advance in knowledge.

The Federal Reserve cannot, itself, raise trend growth. Growth is predominantly the outcome of private sector decisions related to work effort, education, research and development, and saving and investment. Yet public policy can make a difference. Without meaning to overstate the degree to which Congress can raise the economy's growth potential, decisions you make with respect to budget deficits, public investments, regulation and tax reform will be the ones that have the potential to make a difference.

What then is the role of the Federal Reserve with respect to growth? I would term this role "accommodative" and stand with Chairman Greenspan in his comments on this subject in his recent Humphrey-Hawkins testimony. The Federal Reserve should support the full measure of growth that the economy's increase in productive capacity permits. Growth, as I have defined it here, does not cause inflation. It is not a threat. It is the vehicle for higher living standards that we all want to achieve.

I support the independence of the Federal Reserve System. History speaks clearly to the point that central bank independence is a critical ingredient to ensuring a steady commitment to price stability.

Whereas I have studied and written about monetary policy throughout my entire career, I have invested less time and therefore been quiet about the regulatory side of the Federal Reserve's responsibilities. I am now involved in a crash course in these areas. These are important responsibilities.

I shall present here only a broad perspective on the fundamental principles that will shape my views with respect to specific issues. I believe strongly in the value of cost-benefit analysis in the development and implementation of Government regulation. Good intentions are a good start, but they are not an excuse for disregard for the private sector costs of regulatory intervention.

But neither is concern about the cost of compliance an excuse for failing to serve the public good through appropriate regulatory policies. Balance here, as in all such situations, is the rule of reason and the rule I shall strictly apply in these matters if you confirm my nomination.

I want to thank the Committee for the speed with which this hearing has been scheduled. I shall be happy to answer any questions you may have.

The CHAIRMAN. Thank you.

Let me just pose one question to our nominees, and then I am going to reserve the balance of my time for Chairman Greenspan.

One Federal Reserve Bank president recently called for private auditors to be the main examination force of banks instead of Federal regulators. Another Bank president suggested that examiners are not able to monitor the most sophisticated banks any more and thus these banks should be unregulated but lose deposit insurance. What is your view with respect to these two proposals?

Ms. RIVLIN. I haven't examined those particular proposals, Mr. Chairman. I think they sound worthy of examination.

The CHAIRMAN. A good answer.

Ms. RIVLIN. The regulatory responsibilities for the banking system are very complicated, and I think it is a good moment to think about whether this set of responsibilities can be simplified and what role, if any, a private set of auditors might play.

The CHAIRMAN. Mr. Meyer, have you thought about the proposal as it relates to the possibility of less regulation and changes in deposit insurance, because I have to tell you I think we ought to look at this very clearly. The Federal Government is now providing insurance for some kinds of activities that I don't think we ever envisioned. Should we set that aside so that if the Government wants to ensure a person's deposits maybe the bank holding the deposits would be very restricted in using those deposits, perhaps restricted to Federal instruments.

Mr. MEYER. Mr. Chairman, I have only seen newspaper accounts of this. I have not seen the full text of the speech, and I have not been briefed on any material related to it. As a new Governor, if confirmed, all I can tell you is that I will keep an open mind and I will be vigilant in looking at opportunities to reduce costs of compliance and otherwise, but I'm certainly not prepared to reach a judgment on those issues right now.

The CHAIRMAN. My concern is whether there is a way to limit the Federal taxpayers' possible liability and exposure; thereby providing a number of benefits. One benefit is to remove Congress and regulators from what can be a tremendous burden and give some kind of assurance to the small depositors that they will be protected, but by the same token not have the Government involved directly or indirectly in other much riskier activities. That's something I think we're going to examine.

Senator Gramm.

Senator GRAMM. Mr. Chairman, if I could have your permission, I would like to just defer my questions and comments until Alan Greenspan arrives.

The CHAIRMAN. Certainly.

Senator Sarbanes.

Senator SARBANES. I yield to Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

I will just ask a general question of both of you. It seems like many economists have had a difficult time predicting the economy over the last several years, and we hear that signs are good, and we go out and we talk to our constituents and their economic insecurity is very real, despite what all of the facts and figures are that are being given to them from Wall Street. Can both of you take a minute and tell me how you see the economy performing throughout the rest of this year.

Ms. RIVLIN. Let me start. I do not have Larry's proven track record as a forecaster, but I think most of the forecasting community right now is relatively optimistic about the rest of this year, and I would not differ with that.

There was a moment early in the year when things looked as though they were softening a bit, but February's numbers came back very strong and the expectation is that for the rest of the year the economy will be growing near its potential growth.

The mystery that you pose is a real one: Why an economy that is doing so well at the aggregate level is not perceived to be doing well by a lot of people. It's not entirely a mystery. Part of the problem clearly is that many people feel insecure in their jobs, either because they have been laid off, or because they know somebody who has been laid off, or because they read about somebody who has been laid off, despite the fact that we have relatively high employment and a very low unemployment rate. The other source of insecurity is the very slow growth of wages especially at the bottom end of the scale. People are worried with good experience that they will not be able to make it even if they have a job and work hard. So these are serious sources of insecurity.

Mr. MEYER. Let me make a few comments on those issues. After a period of about five quarters of quite slow growth, a little bit below 1½ percent, the economy recently has shown signs of firming. We're seeing a little more resiliency in demand in some of the data, and we now also see that the inventory correction that has been weighing on this economy for most of the last year seems to have run its course. I think prospects are excellent that the economy is going to improve in the quarters ahead and grow near trend over this year.

So we have a situation where we are going to grow near trend at very modest and stable inflation with quite a low unemployment rate. The aggregate numbers, therefore, paint a very, very good picture of the economy, and yet, Senator, I think you are exactly right. I am sure if you talk to your constituents they don't have the same bright feeling. I think there are two things going on here. One is that, on average, this trend rate that we can achieve now is really quite modest, less than half as rapid as it was in the 1960's, for example. So the best we can do right now is a very modest growth

on average. Second, we have seen increasing income inequality. The combination of these two events is that people in the middle, the median family, has really had a sense of struggle. Their real incomes are not going up consistently. This also means that many of the people at the bottom end of the income distribution are seeing their real incomes decline. So I think the aggregate numbers have to be understood in the context of these other developments as well, and it's a challenge certainly for public policy.

Senator MURRAY. Thank you, Mr. Chairman.

The CHAIRMAN. I understand that Chairman Greenspan is here. I am going to take this opportunity to swear in the Chairman and then we will get his remarks.

Chairman Greenspan, we are glad you could be with us.

[Whereupon, Alan Greenspan stood and was duly sworn by the Committee Chairman as follows:]

The CHAIRMAN. Do you swear or affirm that the testimony you are about to give is the truth, the whole truth and nothing but the truth, so help you God?

Chairman GREENSPAN. I do.

The CHAIRMAN. Do you agree to appear and testify before any duly constituted Committee of the Senate?

Chairman GREENSPAN. I do.

The CHAIRMAN. Welcome, Mr. Chairman. I understand you have just come from a little meeting. Do you have any announcement that you would like to share with us?

[Laughter.]

Just between us and we won't let anyone else know.

Chairman GREENSPAN. Can we do it off the record?

The CHAIRMAN. We can even take it off the record.

[Laughter.]

Mr. Chairman, we would be pleased to receive your statement.

OPENING STATEMENT OF ALAN GREENSPAN OF NEW YORK, TO BE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM [REAPPOINTMENT]

Chairman GREENSPAN. Thank you very much, Mr. Chairman and Members of the Committee.

I would like to begin by first expressing my appreciation to President Clinton for nominating me for another term as Chairman of the Board of Governors of the Federal Reserve System. I am honored at the confidence he has shown in me and pledge to him, to you, and to the American people that if I am confirmed I will continue to do my best to merit that confidence.

I also want to thank you, Mr. Chairman, for scheduling this hearing so expeditiously. I like to think that I have had a good, productive relationship with this Committee and the Congress during my tenure at the Federal Reserve. If you and the Senate chose to confirm my nomination, I intend to continue to work closely with you and your colleagues in both Houses on the many issues confronting our financial system and our economy.

As you know, I have come before you frequently to discuss a variety of specific issues related to the conduct of monetary policy and to banking and financial markets. I thought it appropriate on this

occasion to step back from day-to-day concerns and take a bit of a longer view of the forces, especially the evidently more rapid pace of technological change and innovation, that will affect how the Federal Reserve carries out its legislative mandates over the years ahead.

Last month, my testimony was concentrated on the impact of these forces on the economy. Today, I want to address their effects on the Federal Reserve in three main areas of responsibility—supervision and regulation of banks, stewardship of the payments system, and monetary policy.

The way we supervise financial institutions is an area in which technology is both creating problems and simultaneously giving us and the institutions we supervise the tools to solve them. New instruments and changing business practices have made obsolete in many respects our previous emphasis on balance sheets in examinations. A generation ago, a month-old balance sheet was fairly indicative of the current state of an institution. Today, owing to the proliferation of transactions, a day-old balance sheet can be obsolete. Moreover, much of what is important for the health of an institution never finds its way onto the balance sheet, except ultimately through its bottom-line effect on capital. Accordingly, banks and other intermediaries are relying increasingly on statistical models to measure and manage risk. By monitoring these models and by using them to test for vulnerabilities, the Federal Reserve can leverage off of this trend to enhance our own capabilities to ensure a safe and sound banking system.

Ultimately, the smooth functioning of our financial markets and economy rests on the payments system. Congress recognized this when it created the Federal Reserve, making improvements to the payments system one of our preeminent tasks in 1913. We haven't lost sight of that objective, but it has been complicated by the speed and volume of transactions within the United States and between the United States and other countries. Because large shocks can be transmitted rapidly around the world, a breakdown in the payments system anywhere can have adverse effects on the United States.

Here again, technology is being harnessed to reduce the risk of a breakdown, especially by shortening the time that passes between when a transaction is initiated and when it is settled. Events occurring in that period that prevent the completion of the transaction can threaten the stability of the financial system. We have been able to reduce the interval between initiating and finalizing many types of securities transactions, and I expect that reducing it further will be a high priority in years to come.

Ideally we seek a system in which a transaction would be settled when it was initiated. Facilities to do that, however, are costly. Sometimes it is better to accept a minor system risk owing to float, than to invest in resources required to eliminate it. Fortunately, technology is rapidly reducing costs, perhaps enabling the real world to approach more closely the ideal.

We in the United States have a special responsibility, since the dollar is the world's leading currency, and a breakdown in dollar payments would have repercussions far beyond our borders as well as at home. Maintaining the key role of the dollar is important to

American growth and standards of living. Because foreigners want to invest in dollar securities, our markets are more liquid and our interest rates are lower than they would otherwise be. Because foreigners are willing to hold vast amounts of U.S. currency, the interest costs of funding the U.S. Government debt is reduced as a consequence by $10 to $15 billion yearly.

A sound payments system is only one of our responsibilities as the central bank for the world's leading currency. Just as essential is a sound currency—one whose value is not eroding significantly or erratically. But price stability is not an objective you have given monetary policy just to satisfy international investors. Rather, the fundamental reason for this goal is that its fulfillment is an essential element in enabling the economy to reach its full potential.

A challenge we at the Federal Reserve face, as we have discussed on a number of occasions, is to assess how innovation and technical change are affecting the workings of the economy and its response to monetary policy actions. Indeed, technological change has begun to be felt at the very beginning of the policy implementation process, enabling depositories to avoid holding noninterest-earning required reserves and shrinking the reserve base through which we work; we are looking at how we may have to adapt to this development.

Change always presents problems. Nonetheless, I look forward to the opportunity, if you confirm my nomination, to continue to work with you, the President, and my colleagues at the Federal Reserve to help the American people realize the full benefits our innovative and entrepreneurial spirit can bestow.

Thank you, Mr. Chairman. I, along with my colleagues, are open for questions.

The CHAIRMAN. Thank you, Mr. Chairman.

I am going to ask that we restrict ourselves as closely as possible to the time allocated, and that will be 5 minutes for each questioner. We have so many Senators here and I know they all have questions, so we'll keep a strict time limit.

Chairman Greenspan, a recent draft GAO study on Federal Reserve operations was publicly released yesterday. In that study the GAO recommends, and I note that it is a draft, that Congress consider legislation requiring the Fed to impose bank examination fees. Do you agree with that GAO recommendation?

Chairman GREENSPAN. Mr. Chairman, as it stands solely by itself I do not, and the reason I do not is at the moment on average the State member banks pay approximately half of the fee of what national banks charge. The recommendation is to make those equal. If the value of the State charter and the national charter were the same I would subscribe to that, but from what I can judge there are significant benefits that the national charters have which the States charters do not have, and the differential price, so to speak, in my judgment is quite appropriate. If it were otherwise I would have expected a very major shift toward State member bank charters, and more exactly State charters relative to national charters and, as you know, Mr. Chairman that has not happened.

The CHAIRMAN. Well, I think the Congress has been strongly in opposition to that. I can tell you that I share your feeling and I

would be in opposition. I was surprised to see that the GAO would make that kind of a recommendation to be quite candid with you.

Let me say to you there have been a number of critics that allege, and you've heard this, that you have been too cautious in your stance against inflation and that has caused the economy to slow beyond what is necessary to maintain stable prices. What economic and business factors can you point to to refute these critics?

Chairman GREENSPAN. The simplest, Mr. Chairman, is to indicate that the economy seems at this particular stage in recent years to be running at a reasonably good clip, and indeed judging from the state of the labor market clearly unemployment has been lower than it has been at any time in the recent past.

When we observed an acceleration of economic activity taking place in 1994 we immediately saw all of the symptoms that one historically has seen when significant disruptions of an inflationary nature were emerging. This does not necessarily mean that prices accelerate. It means that the underlying disruption began, indeed we saw that the lead times on the deliveries of materials in early 1994 began to rise significantly implying problems on the part of production and distribution, we saw overtime rise significantly, and we saw pressures on commodity prices. All are indicative of the fact that the economy was under strain.

If it was under strain at that point and as late as the latter part of 1994, it's really quite nonconceivable, if I may put it that way, that we have somehow opened up a very large gap in the difference between where the economy is running and where potential is.

However, as I said at the meeting that we had here a month or so again, we nonetheless do not guide monetary policy by trying to determine what we think abstractly the growth rate, however measured, is. What we respond to is not that. We respond to the symptoms of disruption which, in our judgment, have almost invariably historically created the types of imbalances which, for example, in the case of 1994 would have caused a huge increase in inventory investment, excess inventories with a very strong economy for a short period of time, and a very classic major inventory recession sometime perhaps in the latter part of last year.

I think that we have succeeded by the actions we have taken to cut the top off that particular expansion and hopefully have induced a degree of balance and stability in the system which will keep the economy on track for at least the period ahead as best we can see.

The CHAIRMAN. Let me return to another area. We just received a draft report, and again I note that it's a draft report, of the GAO with respect to the Federal Reserve. I would have hoped if that was going to be released it should have certainly been made available to the Committee prior to late in the day yesterday. That certainly seems to me not to have been the way to operate.

Second, there is some question in my mind as to a draft report being released and this Committee and yourself getting simply 1 day to review. I don't know how much time you have had, but have you had any opportunity to review that report, and if you have had an opportunity, what is your response, if any, to a number of the aspects that the report raises?

Chairman GREENSPAN. I have only had a chance to glance through it, but enough to come to certain fairly significant judgments.

Mr. Chairman, in the private sector I was the director of a number of very major corporations of this country. I served on the audit committees of a number of them, and as a consultant I had a great deal to do with the running of those organizations. My experience with the Federal Reserve in a little over 8 years has led me to conclude that this is an extraordinarily well run organization. The types of analyses which I picked up out of the GAO report—I don't want to state that it is just wrong; it has a number of useful things, and indeed I commend them for some of their insights—nonetheless, the general thrust of the report that somehow the Federal Reserve has been profligate in the use of taxpayer funds I find wholly contrary to the facts.

First, we have had, as you know, and this Committee certainly knows, a very major increase in the mandate that the Federal Reserve has had. We have had FIRREA, FDICIA, and a significant increase in our international supervisory requirements. This has created a very substantial increase in the amount of work that we have had to engage in.

The result of this has been a significant increase in costs, less than, I might add, the cost increases of the Office of the Comptroller of the Currency or the FDIC who have a higher concentration in their organizations of the type of work that these two major pieces of legislation required, but nonetheless we did run up costs at a faster pace than we have in the past. However, when you match it against nondefense Federal discretionary spending, we have actually come in under the general level of the Government.

In the report it talks about the fact that we had three times the increase of total Federal discretionary expenditures. Of course, that includes the most important discretionary expenditure, the Defense Department, which has gone down very critically.

It also mentions that our employment has gone up 4 percent from 1988 to 1994 and the discretionary part of the total Federal Government has gone down. Now the trouble with that statistic is while it is true that in the nondefense part of employment there have been modest decreases, and I must admit I compliment the President for accomplishing what he has been doing in that area, but the major part of the decline in employment in the civilian area is civilian defense workers, and to compare what the Federal Reserve is doing, whose mandate is expanding very dramatically, with something which relates to what is involved in the Defense Department, which is going in the other direction, is clearly inappropriate.

My judgment looking at the individual items is that they are measured against the wrong base. I find it really quite extraordinary that our expenditure increases, granted the change in the legislation, have not been very substantially more than we in fact have created, and the reason for that is we are very cognizant of the fact that we operate with unappropriated funds and that we basically have no oversight except the marketplace where our priced services activities, which comprise a large percentage of our outlays, are affected.

Nonetheless, unless we are extremely scrupulous in our budget activities there is nobody beyond us to protect the taxpayer. As a consequence of that, certainly since I have been there, and from what I can judge of my predecessors as well, we have been extraordinarily concerned about what our budgets look like. I have been, and I have worked very hard to restrain the budget, as all of my colleagues have, and I think we have been exceptionally successful in doing that. Aside from a few of the areas which may or may not be accurate appraisals in individual areas in some of our expenses, I have not been able to make judgments on them.

Most of what they conclude, I might add—for example, the Dallas Bank Building, which I must say to you I thought was an exceptionally successful project, I read what this report says and I must tell you I do not recognize the process which I was very closely involved in.

So all I can say to you is that the GAO report is a draft. My impression is that were we to have been observing the final report after we could have addressed some of the elements within it, knowing Chuck Bowsher and his colleagues fairly well and having the highest respect for their capability, there is no doubt in my mind that the tone of this report would have turned out differently.

The CHAIRMAN. We will look forward to that because I think that the Federal Reserve should have the opportunity to have the consultation process, which is normal, with the GAO before unfortunately the report was released in this manner. We could have gotten a better and more complete picture as you have attempted to provide in setting the record straight. So, we thank you.

Senator SARBANES. I'll yield to Senator Kerry.

The CHAIRMAN. Senator Kerry.

OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. Thank you very much, Senator Sarbanes, Mr. Chairman.

Mr. Chairman, welcome. I know that you have appropriately received considerable praise and accolades, and I would just like to say that I think your handling of the credit crisis and the bank failures was frankly masterful and extraordinarily important for the country. You did what a great many Members of Congress were unwilling to do and found a means of creating sort of a long-term resuscitation program that has had a major effect.

We are in good shape, and I would like to ask you if there is not perhaps something being missed in the equation as a consequence of the shape we now find ourselves in?

The banks last year had an all-time record high profit in this country of $48.8 billion. I'm just saying that you have this fact of an all-time profit. Simultaneously consumer debt has soared by 39 percent in the last 5 years and it now exceeds $1 trillion. Personal bankruptcies rose by 6 percent in mid-1995 from the prior year period, and I understand that consumers owe over $360 billion on their credit cards, double the 1990 level. The average household has four credit cards with balances of around $4,800, which is up from two cards and about a $2,000-plus balance. Consumer loans were about 45 percent of bank lending, which is up from 33 percent from about 10 years ago. Nearly 5 percent of credit card loans were

written off as losses last year, which is up about 4 percent from the year before.

Now you suddenly find a situation where consumers are not just paying a college loan or a major purchase with a credit card; they are paying for dental appointments, they are paying for cabs, and they're paying for groceries. You find, an anomaly here, and I want to ask you about that in the context of interest rates and Federal Reserve policy.

Generally we don't see a rise in consumer delinquencies unless there is also an increase in unemployment, but unemployment has been relatively static, and yet in the current situation there has been a rapid rise in consumer delinquencies over the course of the last 6 to 9 months.

I wonder if there is not a transition as we all talk about these changes in the workplace, the nature of work, the downsizing, the kind of cottage industry that is growing, the new startups. Forty million Americans are working out of their homes today, the amount of people accessing the Internet number 30 million and are growing by 300,000 a month. The fact that more Americans are now taking income from either personal employment, self-employment and/or private portfolios, investment than from wages, might indicate a contradiction of forces in the economy and a misinterpretation of how we perhaps decide whether the interest rates should go lower for longer.

I wonder if you would address those forces, particularly the consumer debt and this contradiction with interest rates.

Chairman GREENSPAN. Thank you, Senator.

First, let me distinguish between credit card debt and all other. The main problems that we have seen with respect to delinquencies are in credit card debt, although the noncredit card debt has edged up slightly, but is nonetheless still relatively low.

The reason why we've had a significant increase in delinquencies and in losses in the credit card area is partly the result of the fact that it has turned out largely for the reasons that you have mentioned, Senator, to become a relatively widespread mechanism for credit and, indeed, a profitable one for those who issue the cards.

The reason why there has been this extraordinarily large expansion in card issuance is because it has turned out to be a significant conveniences to consumers and, therefore, a highly profitable item for the card issuers. As a consequence of that you expect, and indeed we are getting, a larger element of loss in these cards, and part of that is calculated by lenders and expected in the sense that people are willing to pay the types of interest rates which they are paying, which as you know are well above the average regular consumer loan, and the fact that they are willing to do that—and indeed in increasing numbers—has led to lenders being willing in turn to accept increased risk.

We think that that could conceivably start to create problems, as you imply, and indeed a number of the issuers are, as best we can judge from some of the reports that we get, are beginning to pull back a bit. Not only is there the $300-billion-plus outstanding that you allude to, but there is also over $1 trillion in excess of unused capacity in existing cards, and as a consequence of that if we just kept going it's obviously of concern as to where that could lead us.

At this moment there is very little evidence that that is a particular problem in the economy, in the financial system, or in the banking community. However, if it is not observed closely and if we don't make certain we know precisely what is happening, there is the possibility that we could find that we have excess credit card problems with other types of difficulties, especially if, as you allude, incomes turn down for one reason or the other.

Senator KERRY. Just a quick follow-up. It is my understanding that on the average about 78 percent of household income is dedicated now to paying off that debt.

Chairman GREENSPAN. Seventy-eight percent?

Senator KERRY. Seventy-eight percent is to pay off that debt.

Chairman GREENSPAN. Our figures are quite a bit lower than that.

Senator KERRY. What are your figures?

Chairman GREENSPAN. They're in the teens. You're talking about the ratio of total consumer debt service?

Senator KERRY. I was talking about those people who fall in that group that have the average of the four cards and the average of that balance.

Chairman GREENSPAN. Oh, I see. No, I'm not familiar with it.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Alan, I want to respond to the GAO study and to this whole economic growth debate because I think it goes to the heart of something that I am very concerned about and I know you are, and I would like to make my comments and then get you to respond.

It seems to me that one strong element of the GAO study is somewhat related to this debate about economic growth, that it never ceases to amaze me that we have debates in American Government about economic growth as if it is just an accident that somebody decided to have low growth and all we have to do is to have somebody decide to have high growth and that we could just make it happen. It's sort of cheerleader economics. It's sort of a free lunch approach which has its proponents in both parties I might add, and one of the things that worries me is that to some extent this, and I see the GAO study is maybe building into it, could become sort of an assault on the independence of the Federal Reserve Bank.

The real power of Congress, as we all know, is the power of the purse, and I think part of the genius of the Federal Reserve Act and the system as it has evolved is the fact that the Fed is a revenue generator and as a result you don't have to come to Congress and present budgets because there is no doubt about the fact that our ability to control your budget could and would over time have a corrosive impact on your independence.

I have opposed self-funding for the SEC, and I have opposed it because I don't think regulatory agencies ought to be self-funding. But there is one thing that is different about the Federal Reserve Bank, and it is the reason that I am totally in favor of self-funding for the Fed, and that is you have the power to create money. I think that if you look at the long history of the system, especially under your tenure, you see the genius of the system in taking poli-

tics and partisanship out of setting the monetary base and conducting monetary policy.

I would just like to say that I think it is important that you go through the GAO's study. I think it is important that you take an objective look at the spending patterns of the Fed. I think there obviously are always problems when you're dealing with a self-funding agency where you're not having to justify to an outside group the expenditure of funds.

I think it is very important that this be looked at internally because I don't want to see the Congress expand its power to get in the business of setting your budget because I would see that over the long pull as endangering the independence of the Fed. So if this cheerleading section of both parties ever gain dominance that you might actually see an effort by Congress to manipulate monetary policy, and if we know anything about world history, it is that no legislative or executive government has ever had the unbridled authority to print money that they haven't abused it.

I would just like to get your comments on that whole subject.

Chairman GREENSPAN. I certainly agree with you with respect to a central bank and that issue. It is very difficult to differentiate monetary policy from all of the other functions that we engage in and they are interrelated. It is precisely the issue that we are given autonomy in making key decisions, and especially because of that, effectively having our own budgetary processes, that we have a special obligation.

While we are not subject to the appropriation process, we do publish in very great detail all of our expenses in every way that we can. We have ongoing GAO audits of everything that we do with the exception of monetary policy. There are people from GAO stationed permanently in our organization to make certain that what it is we do is being done correctly to the extent that we can.

I would be the last one to say that we do not make mistakes. We do, and hopefully when we find them we correct them. But the one thing I can assure you, Senator, is the fact that we take the issue of the fact that the Congress has given us our own budgetary authority very seriously as a special obligation which requires us to be scrupulous beyond what we would probably be were we going through the appropriations process.

Senator GRAMM. Dr. Meyer, would you comment for me on your view on the independence of monetary policy?

Mr. MEYER. I think history, as I said, speaks rather eloquently on this. When a central bank is not independent, then it is too easy for the Federal Government to finance its deficits through money creation. We see that particularly in developing economies without independent central banks and how that can lead to run-away inflation. So an independent central bank is essential. If a government is serious about price stability it has an independent central bank, period.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you.

I would like to start with Dr. Meyer since you have not served that we know of up here in Washington like the other two have. You have made a mark in the economic field on economic forecast

trends and you have certain equations that you use. What are the three most important of those equations to forecast inflation?

Mr. MEYER. It's a very good question, and I think it's important because it turns out that when one does a forecast the model often disciplines one's judgment, but there is often a lot of judgment as well. In the case of inflation, however, I would say that our model did most of the work. Over the years I learned not to use my judgment to try to improve the inflation forecast because the model does such a good job with it.

Senator SHELBY. The model is facing the truth.

Mr. MEYER. The single equation, and I am sure it will come as some surprise to you, but the equation that is the single most important in forecasting inflation in the short run is what we call the Phillips Curve equation which relates wage change to expected inflation and to the gap between unemployment and some critical threshold.

What I would argue is that equation tells us about the process, the structure. That model is fully consistent with the view that the only thing that determines inflation in the long run is monetary growth, but monetary growth operates by affecting aggregate demand, unemployment rates, overheating the economy and generating higher wage change which is then passed on in terms of higher inflation. That's the single most important equation.

The second most important equation would be the equation that links wages to prices. We go from demand slack to wages to prices.

I really couldn't pick out a third equation. The third most important thing is everything else, because everything else really gives us the aggregate demand forces that links monetary policy to aggregate demand.

Senator SHELBY. Along those lines just following up on that, so would you or would you not put a lot of importance on the recent rise in the various commodity prices?

Mr. MEYER. I think one always tracks all available data on inflation, but I think we have to put in perspective the role of commodity prices. If you look at their role in overall prices we find on a value-added basis they only contribute about 5 percent. In addition, they are very volatile, and because they are so volatile when they move rapidly firms aren't in a hurry to pass them on in the form of higher prices because they will have to lower their prices next month when they reverse.

I think we have a lesson in the last year, for example. Go back to about March or April and you take a look at crude prices net food and energy. They increased at a 19 percent rate on a year-over-year basis, stunning, extraordinary, and many, many people were very worried. In the period that followed we had one of the lowest inflation rates we've had in the last 20 years.

Senator SHELBY. Why?

Mr. MEYER. Because commodity prices are very unimportant compared to other considerations like compensation per hour.

Senator SHELBY. Wages?

Mr. MEYER. Exactly. Take a look at the Employment Cost Index, for example. Over the last year it has increased by less than 3 percent. So now you're talking about something that's two thirds and not 5 percent, but two thirds of the cost of production. That's what

really matters. So we keep our eye on wage change, specifically what we call unit labor costs, and that's the most important factor.

Senator SHELBY. Are we in this economy that is mature, to say the least now, are we about close to what some economists, the three of them at the table here, would say is full employment, close to full employment?

Mr. MEYER. My judgment would be that we are basically at capacity now.

Senator SHELBY. Do you agree with that, Dr. Rivlin, capacity, close to it?

Ms. RIVLIN. Yes, I think it is not so much a question of capacity in the usual sense as it is that the unemployment rate is as low as we've seen it in a very long time. As I said in my opening statement, a lot of us wouldn't have thought it could get this low without igniting inflation. Although we aren't seeing accelerating inflation, we aren't seeing decelerating inflation either. So that's sort of an indicator that we are about at the fullest employment that this economy given its potential can attain.

Senator SHELBY. Dr. Meyer, as a soon-to-be member of the Board of Governors of the Federal Reserve, what are your thoughts on the most important thing the Federal Reserve does or should do?

Mr. MEYER. Well, you know, that really is a difficult question when you ask for a single thing. I would say, and I want to go back to my opening statement, that the single most important objective in the long run is protecting the value of the dollar.

Senator SHELBY. Are you saying inflation?

Mr. MEYER. Inflation is No. 1 in the long run. But I am not prepared to leave here and say I've said everything I need to say about monetary policy, that I've told you everything you need to know and that's the only thing I am going to look at because I would be less than honest.

Senator SHELBY. Because there are other things.

Mr. MEYER. Absolutely. I care deeply about whether or not this economy is at full employment just to give you an example. If I told you, for example, that my forecast was different and I thought the economy was slipping into a recession, that the inflation rate is 2½ percent and it had been that way for the last couple of years, would you tell me don't worry about it, ignore it, and be indifferent about it? Well, I won't be.

Senator SHELBY. Don't be.

Dr. Rivlin, what's your conception of the most important thing as a member of the Board, a Vice Chairman of the Board, too, that the Federal Reserve should do?

Ms. RIVLIN. Well, I think that the goal of economic policy, monetary policy, fiscal policy, and all other kinds of policy should be the maximum sustainable rate of growth of the economy. There are several things that could make growth unsustainable. One of them obviously is inflation. The primary goal, because it has the right tools, that the Federal Reserve has to keep its eye on is keeping the price level stable so that growth can be as high as possible.

Senator SHELBY. Chairman Greenspan, do you want to comment?

Chairman GREENSPAN. I don't think I need to.

Senator SHELBY. Because they are doing great.

[Laughter.]

I think you're going to be joined by two outstanding colleagues.

Chairman GREENSPAN. I am delighted at their nomination and trust that in the Senate's good judgment you will act hastily.

Senator SHELBY. After yours we can vote on theirs, right?

[Laughter.]

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I want to welcome Chairman Greenspan, but I do want to direct some of my thoughts to Dr. Meyer. Again, I want to express to you how much I appreciated our discussion the other day with respect to your thoughts and ideas about monetary policy, and I commend you on your statement this morning.

I do want to pick up on one area of it. Someone asked a question and I have forgotten who it was now that had to do with the issue of growth and where does it come from. In your answer you referred to the trend rate of growth and I think you referred to it as being modest. In your testimony you made the following comment, that the Federal Reserve cannot itself raise trend growth and said that the Congress ought to be addressing these issues. In essence how do you raise the potential of economic growth in the country, and you gave a series of areas that we could look at. One of those had to do with tax policy, and let me just read that: "And in sensibly reforming the Tax Code to lower marginal tax rates and ensure adequate incentives for investment."

One of the areas where there has been a lot of attention given to over the last year or so has been the issue of the flat tax, and I believe that you have done some modeling work on the flat tax. I wonder if you would share with us as to whether you think a flat tax, put together properly, would affect the trend that I referred to a moment ago with respect to economic growth.

Mr. MEYER. I don't yet have any firm quantitative numbers there because we haven't run a full simulation of that at this point, but the early results do suggest that flat tax type of proposals have some very positive impacts on the economy by stimulating investment and raising capital formation, et cetera.

I have also felt that tax reform, lowering marginal tax rates and providing incentives for investment, is one of the most powerful tools that we have and that we don't want to throw away. I would say, in particular, that when it comes time to consider tax changes, I would like to see those tax changes as part of the reform effort. It's just too important an objective.

Do you want anything further on that score?

Senator MACK. No, unless you feel compelled.

Mr. MEYER. As an economist I believe that economic incentives matter. Marginal tax rates are a very powerful economic incentive, and I believe strongly in that.

Senator MACK. Well, I happen to share that feeling and I appreciate those comments.

I am going to raise another question and, Dr. Rivlin, you might want to comment on this as well. As you know, I have stated a position over and over again about the importance of price stability to the point of saying that I see the Fed's responsibility as being focused on price stability narrowing and singularly. Critics have

suggested that there are certain things that could happen to the economy for which the Fed ought to respond to. I am thinking of things like how most people would refer to an oil shock, for example, and what does that do to the economy and how should the Fed respond.

So I want to raise a hypothetical question and ask both of you how you would react to it, and again this is a hypothetical question, or I hope it's a hypothetical question. If the Congress passed legislation to increase the minimum wage to $50 an hour, again a hypothetical question, I am certain that you would agree that that would boost unemployment sharply, or at least I would assume that you would. My question then is should the Federal Reserve feel a responsibility to reduce unemployment caused by that hypothetical legislation?

Mr. MEYER. There are two issues here. The first is if you have a major increase in the minimum wage like that I certainly believe that there is some cost in terms of a higher equilibrium unemployment rate. The Federal Reserve cannot undo the damage that you would have done by raising the equilibrium unemployment rate in that case. That would be my judgment. On the other hand, there are also short-term effects, a spurt of inflation that occurs that if the Fed does not change its policy. This will lower the real money supply, raise interest rates, et cetera, and could have a damaging impact on the economy. So, on the one hand, it does not mean that the Fed has no job at all in terms of smoothing the transition there. To the extent, however, that there is a change in the equilibrium unemployment rate, the Federal Reserve does not determine the equilibrium unemployment rate in the economy.

Senator MACK. It sounded like in your second response that the Fed's action would be one taken with respect to price stability.

Mr. MEYER. Well, not necessarily. I mean not in quite the way you might phrase it. Let's say that the impact of this was not only an increase in the equilibrium unemployment rate, and an increase to $50 an hour would result in a major increase in the unemployment rate, but let's say that as well there was a burst of inflation. If the Fed fought that higher inflation immediately by tightening monetary policy at the same time the equilibrium unemployment rate were going up, then there would be a double impact on unemployment that might not be wise. Maybe what the Fed ought to do would be to initially accommodate some of that inflation to limit the near-term hit on the economy of that action. But it can not unwind any change in the equilibrium unemployment rate and it ought to quickly move to restore a sense of discipline in terms of inflation and return toward price stability. I don't think that is inconsistent.

Senator MACK. Dr. Rivlin.

Ms. RIVLIN. I think that's about right. It is a very difficult hypothetical to think about because it's so extreme. But it is an illustration of hard problems caused by some kind of shock to the system, like an oil shock, which changes the parameters and leaves the Fed with a dilemma as to how much to accommodate and how much to restrain.

Senator MACK. One last comment. The reason that I really get concerned about the issue of Humphrey-Hawkins stating a policy

of growth and unemployment is because I really do believe that addressing those issues is a legislative Congressional action. By saying to the Fed that you ought to have that responsibility allows those, as Senator Gramm referred to a moment ago—what was that term that he used?

Senator BENNETT. Cheerleader.

Senator MACK. Cheerleader, whatever—that we use then the Humphrey-Hawkins Act as a means to hammer at the Fed that they ought to be addressing the issues of growth and we take the spotlight off ourselves. We are the ones that affect where that potential growth rate is. If we've got a higher level of taxes on business in America and if we've imposed higher burdens as when you referred to the regulation, we've increased the cost of doing business. We've made it more difficult for us to compete, and yet with the way that the law presently is written politicians can say it's not our fault. We just have a Fed that's not doing its share with respect to growth in the economy.

I thank you for listening to that last comment.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First, I just want to make an observation and I'm not really going to put a question. I'll put some subsequent questions. The statute under which the Federal Reserve is now operating, the law say that the Board of Governors of the Federal Reserve and the Federal Open Market Committee shall maintain long-run growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Now, I just underscore that. Some of my colleagues want to change the law to give the Fed a single goal, and I would oppose that and I think it would be potentially disastrous for the economy. I think the Fed does have a balancing role, but in any event how one comes down on the substance of that issue, until that becomes law the governing policy for the Fed as set out by the Congress is what is now in the statute which embraces maximum employment, stable prices, and moderate long-term interest rates. I just want to put that on the record.

Actually I think we've done a pretty good job in the post-World War II period through I think in part an effective combination of fiscal and monetary policy in affecting the fluctuations of the business cycle.

[Chart shown.]

This is the Great Depression and this is just at the end of World War II in 1946, and this is what we have experienced ever since, and we've shortened the fluctuations and we've kept them almost without exception in a positive growth range, not quite, but almost without exception, as contrasted with what we were experiencing in the first half of the century, and I submit this is a far healthier cycle and economic picture than what we are experiencing since 1890.

Having said that, Chairman Greenspan, I have a couple of questions I would like to put to you, as I am sure you anticipated. If

I am short on the questions and you're short on the answers maybe we'll get through them all. So let's see if we can do that.

First, in early 1994 the Fed for the first time I believe after Federal Open Market Committee meetings issued a statement summarizing the decision taken and has continued to do so; is that correct?

Chairman GREENSPAN. Yes.

Senator SARBANES. Did you issue one today?

Chairman GREENSPAN. Yes, we did.

Senator SARBANES. What did it say? Do you have it with you?

Chairman GREENSPAN. I don't know what it said specifically, but the Federal Open Market Committee adjourned without taking any action.

Senator SARBANES. Now, the question I have to you is these explanations have been very brief indeed and there is some discussion in the economic press and elsewhere that it would be helpful to the economy if we had as it were more transparency from the Fed and therefore a more complete statement as to the basis of these decisions, that that would give people all across the country more guidance as to how the Fed was perceiving the economy. Do you have any reaction to that?

Chairman GREENSPAN. Yes, I do, Senator. We indeed successfully do that I hope with the minutes we release a number of weeks after the meeting after we have essentially vetted them through the Full Committee to make certain that they were correctly characterized. The difficulty with trying to do that very quickly even though we come to decisions fairly quickly in the sense that we vote and we know what we're doing in the sense that we have a vote, but were we to try at that time to agree on a much longer statement of what it is we did and why we did it, I think we would find that our meetings lasted way beyond expectations and we would spend an inordinate amount of time instead of debating policy trying to agree on a communique.

Senator SARBANES. Let me make two suggestions to you for consideration. First is that the Fed do give thought to having a fuller explanation. I mean it's a one-paragraph thing now, and it seems to me that without tying up your meeting an inordinately long time the Fed could give us three or four or five paragraphs that spelled things out. The second is what are the chances of getting the minutes released before the next meeting of the Open Market Committee? Now, I understand that they are inevitably released after the next meeting of the Open Market Committee and therefore they become less relevant, and it would be helpful if they were released in the period in between because it would help to shape people's thinking as you approach the next Open Market Committee meeting.

Chairman GREENSPAN. Senator, the reason we've chosen not to do that is in the minutes themselves are the various contingencies that were discussed during the meeting as to how we may or may not act in the inter-meeting period. Our concern is if those were made public to the market, the markets would adjust to them in a manner which would make it difficult for us to implement policy as we see it in the most effective manner.

Senator SARBANES. Well, you're making it hard to educate us all about the economy in terms of a contribution from the Fed. Let me leave that to one side and ask you this question. Former Governor LaWare in a recent article was quoted as saying:

I often said that when we were assembled together in a meeting that the Governors worked for the staff instead of the other way around.

The same article quoted an unnamed senior Fed official as saying:

You have an institution here with a Board of Governors that supposed by design of legislation to run the place. It is really run by the Chairman and the senior staff with the Board having a certain rubberstamp authority.

Now, my first question is do you have staff at the Federal Reserve who make larger compensation than the Chairman and members of the Board of Governors?

Chairman GREENSPAN. Yes, we do.

Senator SARBANES. Do you know how many?

Chairman GREENSPAN. A significant number, and I will put it in for the record. It's not a small number.

Senator SARBANES. If you could do that it would be helpful.

Chairman GREENSPAN. I will be glad to do so.

[Chairman Greenspan subsequently submitted the following information for the hearing record:]

Of the 1,722 employees of the Federal Reserve Board, 49 have salaries that are higher than the Chairman.

Senator SARBANES. What do you say to the more general observation that the Fed and the Board of Governors are staff dominated, and particularly as it may affect the members of the Board as opposed to the Chairman?

Chairman GREENSPAN. Well, I must say that I almost wish that statement were true, but I fear that it is not in the sense of being somewhat less facetious. The individual members of the Board are major contributors to all aspects of policy. Indeed a substantial part of the policy of the Fed is run through subcommittees, and the subcommittees are chaired by various members of the Federal Reserve Board.

While it may appear that I take action unilaterally with the staff, that is never done without consultation with each individual member of the Federal Reserve Board because all of the authority of the Federal Reserve Board is within the Board members themselves. I as Chief Executive Officer have one statutory authority. I run the meetings, and that is the only authority that I have that comes from the statutes. All of the rest of my authorities come from a majority of the Board of Governors and they can take them away if they so choose. And if I were foolish enough not to recognize where the authorities lie, I would suggest to you that I would be far less capable of implementing policy or running meetings as I think they ought to be run.

Senator SARBANES. Mr. Chairman, I see that my time is up. When the others conclude I may have one or two other questions.

The CHAIRMAN. Certainly.

Senator Faircloth.

Senator FAIRCLOTH. Thank you, Mr. Chairman.

Chairman Greenspan, one of my concerns always before the Senate and after has been the growth of Government. Nearly one in six people who hold a job today work for the Government and this doesn't even take into account those that are employed because of Government spending. This number has been growing continuously. What can we do in the Congress to stimulate growth in the private sector, and I hope we would know what to do to decrease it in the public sector, but we don't seem to?

Chairman GREENSPAN. Senator, in the number of years I've had in the private sector as a consultant and as a businessman myself and effectively running modest-sized organizations it's clear that where growth comes from in the abstract is competition, that is you need a set of competitive forces in a society to create incentives for people to do the best they are capable of doing. When you leave markets open to full competition you invariably get the maximum growth that is the potential for that type of economy.

There are other factors which exist. For example, if you are in an emerging economy whose technology as applied is so below the applications in well-developed economies you have a wide gap to catch up, and if you obtain the knowledge of how the technology is implemented, you have the capability of expanding growth at a fairly rapid pace. But if you're in the forefront of technology, in the outer edge of the best practice, the increments to increased growth are relatively modest.

I think that despite the extraordinary changes that are currently going on, as I indicated in the Humphrey-Hawkins testimony a month or so ago, it is not clear that that very rapid state of change and turmoil is more wheel spinning or true productivity growth. Ultimately, I think we get productivity growth, but the process which we're looking at now where there are very strong competitive forces, and especially in the high technological areas, strikes me as the model we should be looking to to create growth generally, and what that means basically is to create an element of incentives in the system, in the tax codes, in the regulatory codes, and in all of the various other elements in which Government interfaces with the private industry sector and that we try to have a Government policy along with a monetary policy which is best described as a noninflationary environment. If we can create that sort of system I think we will get the maximum growth that this country is capable of engendering.

Senator FAIRCLOTH. Thank you.

Dr. Meyer, one question that has been on the minds of many is whether the stock market will continue to be a bull market going up and up, but the question has more than that. Some think it has to stop. Will this trend in the market continue, and what can the Congress do to make sure that the market is strong? I mean I ask this question because you won an award for economic forecasting, and what should we be doing to make sure that the market is not in a run-away position and continues to be strong and not to cut the growth?

Mr. MEYER. Senator, I will point out that I won that award by being smart enough not to try to forecast the stock market.

[Laughter.]

But I think I can point to at least one aspect here. One of the things which certainly helps the stock market are polices such as deficit reduction which lower long-term interest rates. Those are very buoyant to the stock market. We saw, for example, as a lot of credibility was building about a full compromise on deficit reduction and balancing the budget, there was a really remarkable decline in interest rates over 1995. Some of that was due to this credible deficit reduction story. Now that we've seen the bond markets become more skeptical that this in fact is going to occur, we've seen long-term interest rates back up some.

So if you want to know what you could do to support continued increase in the wealth of households through the stock market, one thing that Congress could obviously do would be to pass a deficit reduction and balance the budget.

Senator FAIRCLOTH. In your opinion, would a balanced budget amendment to the Constitution add to a strengthening of the economy and the markets?

Mr. MEYER. Well, here is where we're going to part company I'm afraid. I do not support a balanced budget amendment, and I think there is no inconsistency for me in supporting a balanced budget and rejecting a balanced budget amendment. Let me explain why.

I said earlier that I'm very concerned about Government's role in maintaining full employment. I worry about the employment side of our objectives. The most powerful thing that fiscal policy does to promote that is through the built-in fiscal stabilizers. When the economy weakens tax revenues fall and the deficit increases. That kind of an increase in the deficit a cyclical increases in the deficit, is not a concern. That's part of the stabilization process.

I would not want to see a balanced budget amendment create an environment in which Congress felt compelled to raise taxes or cut Government spending when the economy moved into a recession, sending the economy even deeper into recession. While I understand that in some of the balanced budget amendments there are escape hatches, to me there shouldn't be any hurdles that you have to jump over to maintain built-in fiscal stabilizers.

Senator FAIRCLOTH. My time is up.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Dr. Meyer, I understand while I was out you had some things to say about the Phillips Curve generally complimentary. I have things to say about the Phillips Curve that are generally not complimentary. Do you want to talk about that a little bit in terms of the iron-clad nature of the notion that the only way you get employment down is to get inflation up and vice versa.

Mr. MEYER. No, that is really not what it says. When people ask me what is the equation that has the most stable predictive power and what is the equation we can rely on most without judgment, as I pointed out earlier, it is the equations in the inflation section sector of the model, specifically the Phillips Curve. I know that comes as a surprise to many who do not deal day-to-day with estimating equations and looking at the data. Many of my colleagues in economics are surprised when I tell them that.

But the fact of the matter is that this particular relationship, the so-called infamous Phillips Curve, is a powerful predictive compo-

nent of my forecasting ability. I must say that I doubt that I could have possibly won the forecast award over this period had I not relied so completely and depended so heavily on the Phillips Curve in our model.

Senator BENNETT. But is that a short-term phenomenon, or are the two inextricably linked so that you have to make policy on one area to affect the other? That's a more significant issue for you as a member of the Fed.

Mr. MEYER. The Phillips Curve describes the structure of the inflation process. It is not at all inconsistent with the view that I hold very firmly, that money growth in the long run is the principle and virtually exclusive determinant of inflation. But when monetary growth picks up how does it get transmitted to higher inflation? The answer is that higher money growth stimulates aggregate demand, lowers the unemployment rate, and raises wage change, which gets passed on in the form of higher prices. That is how the inflation engine begins. Something has got to start the process, and it is monetary growth that starts the process. This is part of the structure of the economy and, as I say, it is a very, very stable part of that economic structure. If you were to tell me to leave that Phillips Curve home, I would be a lot less valuable as an economic forecaster.

Senator BENNETT. But that's not the point I am getting at. I understand some people say well, if unemployment is going up that means we have to fight that and we have to bring full, and if we have to pay an inflationary price to get full employment we're willing to do that as a matter of policy. That is what scares me.

Mr. MEYER. That's not the way our model works. The way our model works is that there is absolutely no long-run tradeoff between inflation and unemployment. In the long run the model gets back to this full employment point, and the Federal Reserve through its policy will determine at full employment what the inflation rate will be. That's the way the model works. There is absolutely no long-run tradeoff, and there are absolutely no benefits to be derived for the economy by speeding up inflation in the prospect that you could sustain a permanently lower rate of unemployment. The model says that just can't be done.

Senator BENNETT. I agree. I'm glad to hear that.

Let's talk a little bit about unemployment and its connection with interest rates and monetary supply. My experience tells me that some unemployment has nothing whatever to do with interest rates and the monetary supply, and that's increasingly becoming the case. For example, we've gone through a round of BRAC hearings in the Congress downsizing the Defense Department.

The President in his State of the Union message makes a great point out of the number of civilian employees that have been laid off since he has been President, and his aggregate numbers are correct. The vast majority of those numbers come out of the Defense Department, and if you close a defense facility, as we have done through BRAC, and I agree with the fact that they should be closed, and I am not one of the ones who says keep facilities open just because they provide jobs.

But you have enormous dislocations that occur at least in the short run, and in this case the short run in terms of the individuals

concerned seems pretty long because if you've been a career Defense Department employee at a defense facility for 20 years and then you're told, OK, hallelujah the cold war is over and you're laid off now, that has nothing to do with interest rates and it has nothing to do with monetary supply. That is just the reality of what has happened, and that's where most of the downsizing in the Government has come is in the Defense Department.

Then you have the circumstance that I think the Chairman was alluding to the tremendous changes in the economy by virtue of technology, and what do you need middle management for. Well, middle management provided a very worthwhile service in the corporations of the 1950's, 1960's, and 1970's because middle management existed to manage information.

Now with the PC on the factory floor the team that is assigned to building the automobile or whatever it is can get information with a key stroke more rapidly than an army of MBA's used to be able to process it, and this has nothing whatever to do with monetary policy. The unemployment is coming because all the MBA's are laid off. They have been made obsolete by Bill Gates, if you will, and of course by Novell that's located in Utah. It's a competitor to Microsoft.

Do you take those things into consideration, or is the economic model locked into the computer and it says these things are all intertwined and if you see a change in this number we change it in that number and that drives everything, or do you look at things like defense closings and the downsizing of the defense budget and the impact of technology on unemployment?

Mr. MEYER. I certainly look at that qualitatively. The kind of structural adjustments that you're talking about, massive changes between defense and nondefense sectors and corporate downsizing, can lead to dislocations and raise the average unemployment rate for a period, having nothing to do with the state of aggregate demand. As some jobs are eliminated, these people have to find places elsewhere in the economy. Think how remarkable is it nevertheless that in this period of incredible change and corporate downsizing and structural adjustment that the unemployment today is 5½ percent.

The economy is extraordinarily resilient. We are creating a lot of jobs, because not only are we creating jobs for people coming into the labor force, but we're also creating jobs for all these people who are being downsized and who are moving out of defense, et cetera. So the economy is really doing a quite outstanding job, and I think the credit goes in part to monetary policy for keeping the economy on a steady keel during this period of significant transition.

Senator BENNETT. Thank you. My time has expired.

The CHAIRMAN. I want to apologize to my good friend, Senator Domenici, Chairman of the Budget Committee, who is sitting next to me. I just skipped over him. That is what he gets for sitting next to me.

Senator Domenici.

Senator BENNETT. That makes the second time I have gone out of turn.

The CHAIRMAN. The Chairman did this one.

Senator DOMENICI. I want to talk about three different topics, but do it as quickly as I can. My staff tells me that on TV the other night in a 20-minute timeframe there was a TV piece on buying a car over the Internet. The transaction involved shopping for the car on the Internet, paying for the car through electronic banking, and then transferring the title electronically. So those who don't like used car salesmen, we're about to get rid of them, right.

On the other hand, within that same 20 minutes a story was on about people having their bank accounts emptied, and emptied electronically just by giving an unscrupulous person their account number. The computer was the accomplice to that crime.

Now, Mr. Chairman and Members, we rely heavily upon the Federal Reserve's capacity to avoid systemic risk in the banking system of America, and we charge you with being our watch dogs in that regard. I would submit to you that the chance of something going wrong with the banking system big enough to affect America's economy is not going to go wrong in the old conventional way, but it's going to go wrong because of new equipment and technology.

You said a month-old balance sheet is out of date, and that really means things can happen like that, and I just want to suggest that we place our confidence in you and it is absolutely imperative that you get the very best technical advice on computers and software so that you're on the right wavelength with reference to regulating banks with new technologies.

Could I just have an observation from any of the three of you, perhaps you, Mr. Chairman?

Chairman GREENSPAN. Senator, we do have highly skilled people, and it is essential that we have those people who understand the process, the software and the technology for precisely the reason that you make.

The structure of our staff has changed I would say quite dramatically in the last 20 years. We used to have a number of people who were involved in moving paper around, clearing checks and large numbers of people counting currency. What has happened is a dramatic change which effectively has mirrored the technological changes in the financial system and in the economy in the central bank.

One of the reasons why we've had a rise in costs which the GAO is concerned about is not only have we had our mandate increased by the statutes which I alluded to, but we also have an extraordinarily important increase in the technical skills of the staff of the Federal Reserve, we have a very large number of people who know how these systems work and a large cadre, as you know, of Ph.D.'s, not only economists but others, and we are there just because we have to backstop the problems that you're concerned about.

We're not going to get them all because the change in technology is really quite extraordinary. We've spent recently, for example, a good deal of time and concern on what is called E-cash which is related to the type of Internet transactions that you are concerned about. If we found ourselves inadequately prepared to understand the system as well as those who use it for purposes of fraud, I think we would end up with a level of fraud which would be utterly mind boggling.

While we don't have cryptographers as such as full-time staff members to create the nature of the software which would basically block the use of various different types of programs to infer what people's code numbers were, we know where to get it and we know what it is when we look at it. Whatever it is we're doing now, the job is going to become twice as difficult 10 years from now.

Senator DOMENICI. Dr. Meyer, do you have an observation?

Mr. MEYER. No, not beyond that.

Senator DOMENICI. I have one parochial question, and then I want to ask you about growth and wage stagnation. We've experienced an increasing number of bank consolidations. In my State, which is a small State as you know, we have had a number of consolidations there. Do you see any evidence that suggests that bank consolidation is adversely affecting the credit availability to small businesses and to small communities?

Chairman GREENSPAN. I do not. There are others, especially a recent study by a member of the Federal Reserve who in an analytical way concluded that that might be possible. I have not seen any evidence of it, and I must say it's a highly disputable conclusion.

Senator DOMENICI. It's important that you do everything to make sure it's not happening, right, so that we'll know about it.

Chairman GREENSPAN. Yes, sir.

Senator DOMENICI. Let me take a couple of minutes on the issue of wage stagnation. It seems to be the issue in our country right now and the politics of the Presidential election center around wage stagnation. Everybody is suggesting in their campaigns that corporations ought to do things differently the idea apparently being that if they did things differently on downsizing and other reorganizations maybe wage stability and anxiety about jobs might ameliorate.

Let me ask each of you in your expert capacity, first, is wage stagnation over the last 15 years true or false and, if it is true, what should the United States be doing about it?

Let's start with you, Dr. Meyer.

Mr. MEYER. Well, the data is clear. If you look at the aggregate data basically wages are about productivity growth, and productivity growth has increased about 1 percent per year from the early 1970's onward.

Senator DOMENICI. Could we be measuring productivity improperly?

Mr. MEYER. Certainly it's very difficult to measure, and let me say this. The economy could be growing more rapidly than we currently believe it is, but that would be very inconsistent with the widespread insecurity. So I don't know that you really want to press on that score. I mean when you talk to your constituents and they tell you that they're concerned about their living standards, they know the truth. We don't need to go there and tell them what's happening to their wages. They know what's happening to their wages and they know what's happening to their standard of living, and there is a problem out there.

So we are in a period, as I indicated, of very modest average growth in productivity. In addition, we have increasing income inequality so that many families have been facing a stagnation in their real wages, and a significant portion of the population has

been facing declines in their real wages. This is the reality, and this is certainly a serious challenge for public policy.

Senator DOMENICI. So am I reading you right that you are suggesting the only way to do this without inflation is to increase productivity substantially more than we are now?

Mr. MEYER. That's the game. The standard of living is about productivity.

Senator DOMENICI. Do you have any suggestions as to how we might increase productivity?

Mr. MEYER. Well, I think that productivity is basically about two things: Capital per worker or the capital stock and knowledge. We can increase capital formation by increasing national savings via a reduction in the budget deficit. We can increase labor productivity by increasing the skills through education and training. Those are other areas that are certainly very important.

Senator DOMENICI. Some people seem to imply in this debate that corporate stock prices are too high and it ought not be so high and that in some ways that's detracting from what is being paid to workers. Is there any reality to that?

Mr. MEYER. I really do not see this as a battle between the holders of equity and workers. Workers on average get paid at a rate consistent with their productivity, and if we want to increase the standard of living of American workers then we've got to work very hard to increase their productivity. We have to work very hard to avoid reducing their productivity through bad legislation and we have to work very hard to increase their productivity through good legislation. That's what it's all about.

Remember, too, that a lot of the declines we have seen in the rate of productivity growth occurred from in the 1960's to now. In the 1960's productivity was growing around 3 percent or 3¼ percent. It is about a third that rate now, and we can't even explain why most of that decline happened. So I can't tell exactly how to reverse it because I can't explain why it happened in the first place. I also want to note that there is a limit to how much you can raise productivity with policy. But you can do something and we've got to try.

Senator DOMENICI. Dr. Rivlin.

Ms. RIVLIN. I would agree with the general thrust of Larry's remarks. Clearly productivity is the key to raising wages, and we need to try everything we can think of to raise productivity. As to raising savings, the most obvious means is the one you've been most concerned with, and that is getting the budget deficit down. We know how to decrease Government dissaving, but we don't know very well how to increase private savings. We ought to do first the things we know how to do. I think more effective training and education and more investment in science and technology are the things we need to be doing.

There is the additional problem that even if average wages are rising, wages at the low end have not been. We need to focus the investment there, the training and the education. There are also other things that we can do with the tax system. The earned income tax credit helps improve the incomes of low wage earners.

Senator DOMENICI. Mr. Chairman.

Chairman GREENSPAN. I am in general agreement with what has been said with respect to the causes of productivity, including Dr. Meyer's concern that we don't know fully why the productivity rates have fallen from where they were in the 1960's unless we argue that the 1950's and the 1960's were largely a catch-up from the unemployed knowledge, if I may put it that way, of the 1930's and the 1940's, and that the unusual period was the immediate post-war period and not the period in the last 20 years. Nonetheless, there is no doubt that unless and until we can move productivity up more than it appears to be rising there is very little out there in the way of long-term economic growth.

The only area which I would merely raise, which has got really nothing to do with the real world but just the perception world, is that it is likely that we do underestimate the rate of growth in productivity in the sense that we expense a number of items that we should be capitalizing, an issue which I raised in my Humphrey-Hawkins' testimony, but there is no question that if you wished to increase productivity certainly a necessary condition is the low cost of capital, and for that the most important thing that Government can do is not only bring the budget deficit down to balance and even into mild surplus, but keep it there, and that is very important and perhaps the most important current issue which I believe Government can do and should do as quickly as we can find a way of doing it.

Senator DOMENICI. Dr. Meyer, you mentioned a while ago on the flat tax that you had some analysis, and that while your model wasn't complete that there might be a positive impact on the economy from a flat tax. Have you happened by any chance to have looked at the USA tax that Senator Nunn and I have proposed with reference to a whole new way of creating an incentive for investment and savings and do you have any thoughts about it?

Mr. MEYER. I'm somewhat familiar with that tax, but we haven't made any efforts at this point to simulate its effects. I do want to go back to the flat tax because I don't want to leave any misimpressions. If I were to put the flat tax into the model I believe it would generate some positive economic results, but I would not be oblivious to or ignore some of the impacts on the distribution of the tax burden, and I wouldn't want to be on record as supporting the flat tax at this point by any means.

Senator DOMENICI. I have one more question if you would permit me, Mr. Chairman. There is some discussion about American corporate activities as they relate to growth and size. Some seem to be suggesting that American corporations, because they're getting too big, are not necessarily good for the working men and women who work for them. Would somebody just tell me if there is any evidence of that? Some seem to be suggesting that there's a problem with American companies. I remember 15 years ago they were not able to compete in the world and everybody was worried about whether American jobs were going to disappear because of a lack of productivity and quality of product. We have solved most of those. Is corporate America doing a reasonably good job in that respect in paying their workers and putting people to work and those kinds of things, or are they part of the problem?

Mr. MEYER. I think that corporate America and American workers together have moved the United States into a very powerful competitive position in the world economy. Bar no one, we are a very competitive economy in terms of selling goods abroad, and we can see that in terms of the buoyancy of our export growth recently. So I don't see that there is a particular issue there. Remember these problems began in the early 1970's well before the phase of corporate downsizing that we're seeing now. So we have a longstanding problem with slow productivity growth that well predates the issues I think that you're referring to.

Ms. RIVLIN. Could I add to that. The place where we are doing quite well with respect to productivity is the manufacturing sector, and there we should be very pleased at what has happened over the last few years. That's where most of our big corporations are. What is more worrisome I think is the productivity of the rest of the economy, the service economy and the small enterprise economy where some are doing very well and some are not.

Senator DOMENICI. Dr. Greenspan.

Chairman GREENSPAN. Senator, I am very suspicious of the data that we have largely because it's hard for me to believe that when you subtract what Dr. Rivlin was mentioning, namely an exceptionally strong manufacturing productivity, from the implicitly measured aggregative productivity you get a very slow pace of productivity growth in nonmanufacturing. Nonetheless, profitability in that area is quite significantly improving, and it just strikes me that there is something wrong with our data system which is not internally consistent with what one sees on a day-by-day basis in corporate America.

Senator DOMENICI. Mr. Chairman, thank you for letting me go over a couple of minutes, and I want to add my words to the three of you on the one thing that since I've been here has convinced me that we need an independent Federal Reserve, and I hope you all know how important that is to America's future as most of us understand it. Frankly when we consider how difficult it is for Congress to lead on matters of long-term significance, and we're pretty good on the crises, but we're pretty weak on the long-term strategic thinking, I think we ought to be very pleased that a long time ago we created an independent Federal Reserve.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I wanted to return, if I might, and I raise this with the Chairman, Ms. Rivlin, and Mr. Meyer, to the issue that Senator Domenici touched on as it related to a recent paper which was submitted by, I think, one of the Federal Reserve economists. An article appeared in the American Banker a week ago Thursday on March 14 in which Allen Berger, who is this economist, said that the fall-off in small business lending is the result of thousands of bank mergers that have taken place.

Berger goes on to say that the banking industry consolidation will further depress and undermine small business lending. Berger declared that large banks historically commit less of their assets to small business loans than do small banks. He said this held true in 1994 when the big banks devoted just 2.5 percent of their loan volume to small business lending while contrasting that with the

smaller banks that made 82 percent of their volume to small business. Berger co-authored this paper with an economist from the University of Chicago, Anil Kashyap and another Fed economist, Joseph Scalise. They found a clear relationship between the creation of the first interstate banking companies and the drop in small business lending.

Now I know, Mr. Chairman, that you have indicated that you have some doubts with respect to their findings. Do you care to comment on that? And let me suggest this. I think it is terribly important for the Fed to look at this issue. I believe that maybe one of the branches, maybe New York, did a study that is contrary to this. But we really need to look at this issue very closely because if we believe that the engine of economic growth and opportunity is small business, we've got to assure that those capital markets are open.

Chairman GREENSPAN. I certainly agree with that, Mr. Chairman Let me just say first that if the figure is 82 percent of the loans of small banks are to small business, the answer is that's precisely what one would expect because it's very difficult for a small bank to make a sufficiently large loan to large business.

The crucial issue really rests with the large banks making loans to small business. Where we do not know and cannot know what will happen as institutions merge, if in effect you eliminate small bank lenders and therefore tighten the loan market, the issue is whether you will get other lenders coming in. All the evidence that we have says that they will.

Certainly if you look at the surveys of the National Federation of Independent Business, which is the trade association for small business, they always ask on their monthly survey whether they're having credit problems, and there is no evidence of that for a long period of time.

My own suspicion is that what we are looking at is a statistical artifact analysis here. As I said in my answer to the previous question on this subject, there are a number of people within the Federal Reserve staff who disagree with the results that Allen Berger and his colleagues produced. It's a disputable issue, but far more importantly if we see that there are in fact small business lending problems as a result of the consolidation process that is underway, I can assure you it will get our attention very quickly and we will look for remedial measures.

The CHAIRMAN. Ms. Rivlin.

Ms. RIVLIN. I am not familiar with the article, but I will certainly read it with interest and see what I can make of it.

The CHAIRMAN. Well, I think it's just terribly important that we be very sensitive to the impact of consolidation. I'm not coming out against consolidations, but I'm just suggesting that we had better be very mindful that we don't choke off credit or make it disproportionately difficult for the small business entrepreneur.

Ms. RIVLIN. Absolutely.

The CHAIRMAN. Mr. Meyer.

Mr. MEYER. I agree. This needs scrutiny and attention, and I will look forward to looking over that study and worrying about this problem. It's a significant and an important one.

The CHAIRMAN. We would be very appreciative. I'm pleased that the Chairman indicated that the NFIB has some kind of a monitoring system. I think I'm going to ask the staff to keep in contact with them specifically as it relates to assuring or trying to get some measure as to what impact this has with respect to available credit through those small business communities.

Senator Sarbanes.

Senator SARBANES. Well, Mr. Chairman, I'll be very brief because I know you're drawing this panel to a close. I have a couple of observations.

First, Chairman Greenspan, I would hope that the Fed might pay attention to the problems of small business and getting credit without necessarily linking it to as a result of the consolidation or merger process. I mean there may be a problem in any event.

I note that Governor Lindsay has been very active with the neighborhood housing services movement across the country, the consequence of which has been through a combination between the banks and community groups to develop rather exciting programs to enable people to become first-time homeowners. In fact, the American Banking Association has prepared specific like little textbooks to lead people into home owning that addresses a lot of the questions and they're very well done, and I think this is an example that there really is a market there if people will just recognize it and work a little bit at developing it.

I'm just raising the possibility that the same prospect may exist to some extent in the small business area, and perhaps the Fed should address it in a more affirmative way rather than looking to see whether there has been a detrimental impact.

Second, on the wage issue I think I'm correct, and, if not, I would like to be corrected by people on the panel, that while the share of the national income going to the wage and salary accounts has not changed much over this period of time that we were making reference to before when we talked about wage stagnation, that there have been notable shifts within the wage and salary account that suggest that the benefits of whatever increase in productivity has taken place have gone very much to the upper end of the wage and salary accounts, which of course would explain—I mean it is reflected in part by the growing disparity in ratio between what the worker on the shop floor makes as compared to the chief executive, and it is reflected in these very high compensation packages for chief executives, and I think I am correct that the studies have shown that that kind of shift within the wage and salary accounts is taking place to the detriment of low- and middle-income workers. Is that correct?

Ms. RIVLIN. That is substantially correct, but another way to look at it is the extremely high compensation of executives doesn't matter much in the aggregate statistics because there aren't enough of them. What does matter is that people with substantial skills and education are earning more relative to people in the middle and with little education. That's a hopeful sign in some ways in that it suggests something we can do about it, that increasing education and improving the quality of education may be keys to increasing incomes generally and incomes at the bottom of the scale in particular.

Senator SARBANES. Finally, Mr. Chairman, I'm a little concerned, and I'm not sure, but I hope this GAO report is not simply being dismissed. I understand it's a draft report and you're going to have the opportunity to comment on it, but it seems to me it does need to be taken seriously and addressed in a serious fashion.

The New York Times story says that:

Contracting and procurement practices at some of the Reserve banks favored certain sources over others despite systemwide guidance that prohibits this. Such practices raise questions about conflicts of interest and favoritism and whether the system is receiving the most favorable prices.

The Wall Street Journal story says:

Some Fed inefficiencies identified by the GAO result from its decentralized and quasi-private structure the investigator said. They also said many shortcomings identified in the reports are being addressed by the Fed with some already corrected.

That raises the question of not only the operations of the Fed here in Washington, the central office as it were, but the operations of the regional banks and the need perhaps for the Board of Governors to scrub down those operations more carefully.

I am not trying to argue the point, but I'm just suggesting that you've got this study and I think it needs to be treated with some seriousness, and to the extent that the criticisms rendered therein have any validity obviously I would assume the Fed would intend to address them.

Chairman GREENSPAN. Yes, that's certainly the case, Senator. As I indicated in my earlier answer to this, there is a lot in the report which I think is useful. I thought, for example, the particular suggestion about whether or not we could use our bargaining power to obtain better medical costs by bringing the 12 banks together rather than each of them negotiating separately is well worth looking into.

The issue of contracting inefficiencies we will look at, but let me just say for the record that it is true that we do have guidelines, and they are guidelines in the sense that they're not mandatory structures for how contracting should be done. We interact with each of the individual 12 banks on all of the contracting, and the reason there is this problem about when do you have competitive bidding and when do you not is really a business judgment as to whether in fact for certain relatively small types of ongoing services does one really gain by changing the vendors all the time, and that's a business judgment. In some instances I think it is a mistake to have competitive bidding and change your vendor each time, and in other conditions it is mandatory that you do because you have the possibility, as was indicated, of special interests creating what is clearly a wholly inappropriate process. It is a very complex issue and one which is not simply defined in terms of a rigid code which can apply to everything. We do at the Board oversee all of this, and as best I can judge it seems to be going rather well.

Having said all of that, I do nonetheless think that when we have a number of people as skilled as the people at GAO are and experienced looking at our various different structures it is incumbent upon us to take a close look. I think it is quite conceivable to me that some of the issues that they have raised when we examine them we're going to find out that they are right and we are wrong.

My basic objection to the report is not some of the individual recommendations, which are subject to business judgment and subject to questions of whether one can improve and one certainly can, but it's the overall conclusion. We have been confronted with a very extraordinary expansion in what we're looking at with respect to our mandates statutorily and a very rapidly changing technological system and our basic objection is that the report looks at our costs and measures them, in my judgment, in an inappropriate way. My own suspicion is that were we to sit down with GAO and go over in considerable detail as to where our costs could have been different, I suspect we'll get a change in the tone of that report.

What is clearly not the case is you cannot basically take the total discretionary part of the Federal Government or the fact that commercial banking is under considerable cost squeeze and contraction in a goodly part of the 1988 to 1994 period and argue that we should have had significantly lower costs. I have looked every year at how we could cut costs and I must say to you that I have found great difficulty.

But also when we look at such things as our building projects, I went through that Dallas Bank thing quite extensively and we came in way below budget saving considerable amounts of money. I think the actual costs were more than $15 million less than originally budgeted.

It is true that we ended up with a larger amount of square footage than we originally had anticipated largely because when we started to look at the building codes that were involved and we got the details we had to move some of the security areas of the bank. Instead of using streets outside of the bank to move trucks around, we had to do it inside, which meant we had to add more square footage to the total project. To say that we also had 2 acres more than we originally contemplated, the answer is yes, it is true, because we couldn't get other square footage which was exactly what we had in mind. We didn't expend as the report says. It didn't cost the taxpayers $7 million more. That property is worth a lot more today, and if we were to sell it off we would make a profit. It's not a cost. It's an investment.

It's those sorts of things in the report which as I go through it I must tell you having worked so diligently to try to keep our costs down makes me discouraged that we didn't have a shot at trying to bring to the GAO people our perspective.

The CHAIRMAN. Now in fairness to the GAO I must say, Mr. Chairman, that I do not believe that they anticipated that this report would be made public and that they fully intended to have an opportunity to sit down with you, that's what I've been given to understand, to review this. So it's unfortunate that it was made public I think precipitously so that you didn't have an opportunity to meet with them and resolve some of these matters.

Chairman GREENSPAN. Let me say I suspect at the end of the day that GAO report is going to be very worthwhile because it's very useful to have somebody look over your shoulder periodically at all of the things you've been doing on a day-by-day basis. As I indicated very early on, my experience on the audit committees of a number of major corporations suggested to me that that is a very valuable activity. While I may disagree with some of the broad

thrust and some of the broad conclusions and a number of the details, that is not to say that I think the report is something which may not be of very significant benefit to our management.

Senator SARBANES. There may be a problem in terms of the review within the system of the activities of the Federal Reserve Banks as opposed to activities of the Board itself. I note that the number of people who make more than the Chairman or the Board of Governors is significantly greater out amongst the Federal Reserve Banks than it is within the Washington staff.

The thing that I thought was interesting is the article that says: "The size of the staff rose 4 percent from 1988 to 1994, but total compensation costs rose 53 percent in the same period." Then it goes on to say: "With respect to benefits the cost increase during that period was 91 percent while the increase for Federal employees generally was 62 percent." So there is a difference there.

Chairman GREENSPAN. There is, Senator. First of all, the reason for the average salary increase, as I indicated before, the nature of the people who work in the Federal Reserve System has really quite dramatically changed because of technology, but the very large numbers of people who used to be at the banks in moving currency and checks are no longer there because it has all been replaced by equipment. So that you would expect as the technical skills of the work force move up, as indeed they have, that the average salary has moved up quite appreciably, although the fixed weight average increase in salary has not. It has been very close to the average of various competitive models.

On the benefits issue we found the number that is in there difficult to understand. We think it's probably arithmetically correct, but people in our organization who are in charge of that are looking at the numbers in detail because it struck them as a little bit out of line from what their expectations were. In any event, we will examine it and take a look at it and double check it with GAO.

The CHAIRMAN. Well let me at this point assure my colleague that it is my intent to see to it that the Banking Committee will review the final GAO report and incorporate it into our oversight responsibilities. I think that's important. I would hope to invite GAO to come in after they have a meeting with the Fed to brief our staff and then hold hearings if necessary. I want to commend the Chairman for his enlightened approach to this, and that the report may be a very useful tool in increasing the efficiency and the effectiveness of the work that is carried on. So I commend the Chairman.

I want to thank our three nominees for coming in today, for making themselves available and for their forthrightness and candor. At this point in time we thank you, and it is our intent to move the nomination process as expeditiously as possible.

Thank you.

We have another panel. I would ask that those who are going to leave hold it down so that we can continue to move the process.

[Pause while Ralph Nader comes forward.]

The CHAIRMAN. Our next witness is Mr. Ralph Nader.

We're pleased to receive your testimony.

OPENING STATEMENT OF RALPH NADER ON THE NOMINATION OF ALAN GREENSPAN AS CHAIRMAN OF THE FEDERAL RESERVE BOARD

Mr. NADER. Thank you very much, Mr. Chairman and Members of the Senate Banking Committee, for the opportunity to comment on the nominations and the Federal Reserve Board policies in general.

I believe there is a need for change at the Federal Reserve not only to make the agency less wasteful and more open and more effective and more responsive to a broader segment of the American economy, but also to raise the issues of how remote the indicators are now from empirical reality.

I think there are an increasing number of economists who are troubled by the narrow range of the national income accounts, who think that the unemployment rate masks a great deal of underemployment and people who have given up looking for employment and who would like to broaden the indicators for the GNP and other measurements of economic progress or regress to look for the depleting data, the so-called quality of the economy and not just in its distribution of its fruits, but also in terms of what it ignores lie the sustainability debate.

When I hear, for example, Mr. Meyer talk about 5 to 6 percent unemployment, conventionally defined, meaning that the economy is at capacity and that anything beyond that would raise inflation, et cetera, I think of other data, that between 20 and 25 percent of the children live in poverty in this country.

Are we really true to ourselves by restricting our narrow definition of unemployment in the first place to exclude underemployment, people who have given up trying to find employment and not including an indicator like child poverty. It seems to me that this is just one example of many which calls for broader frames of reference in evaluating both the Federal Reserve Board and the performance of the Governors of the Federal Reserve Board.

I am struck by the time that the Senate gives to analyzing the record and performance of nominees to the Supreme Court compared to the time given to analyzing the record and views of Members of the Board of Governors of the Federal Reserve. True, they do have different functions, but they both have very important functions, and I thank you, Mr. Chairman, for at least shall we say breaking precedent and allowing a bit of testimony from a different perspective.

Looking at the Federal Reserve over the years I would have liked to have seen more talk about precisely what is productivity and productive capacity in an economy and precisely why the Federal Reserve is behaving today as if the fiscal policy expansion of the Federal Government is as it was in the 1960's and 1970's, which it clearly is not. It's in a contracting stage.

I would like to have the Federal Reserve muse out loud why it acts so much as a prisoner of the bond market, which is behaving rather irrationally and goes down when there is good economic news, and that's not a very good pattern of market behavior to be a guide post for Federal Reserve concerns.

I would also like to see more focus on perhaps one of the central economic issues of our time, the economics of the innercity in our

country and how the Fed can use its awesome powers to encourage investment in the innercity by a variety of creative policies and programs.

The Fed has massive research capacity and sometimes one thinks that this research capacity is more designed to serving concentrated power rather than the proliferation of more productive use of capital. We have an amazing economy where there are huge pools of capital invested in abstract instruments, increasingly more abstract, I would say, derivatives and so forth, and at the same time we have huge capital needs in the real economy, in the empirical economy back home where people live and work.

Now my testimony I would submit in its entirety with your permission, Mr. Chairman.

The CHAIRMAN. So ordered. We will receive your testimony and it will be made part of the record as if read in its entirety, but you proceed and take those parts out that you care to.

Mr. NADER. Thank you. I also would like to submit some supporting material as well.

The CHAIRMAN. So ordered.

Mr. NADER. We have seen in recent weeks I think an increasing public alert to the question of the quality of the economy, not just aggregate data, but how it is finding its way or not finding its way to the betterment of the majority of the people of this country. The New York Times used hundreds of columns of inches recently to chronicle the new era of economic insecurity in its seven-part series.

Now the President's decision to keep monetary policy reins in the hands of Alan Greenspan, I think, is a decision to continue the present status quo policies, and while disagreeing I have no illusions about the ultimate outcome of this nomination. For 8 long years the Congress has seemed willing to accept most, if not all, of Alan Greenspan's bland assurances when he visits Capitol Hill twice each year to report on monetary policy.

But I would like to focus on the issues that people like Wright Patman and other long-time Congressional critics have brought to bear to the Federal Reserve.

The first issue needs to be considered in the context of what Senator Sarbanes properly remind us, that the specific mandate added to the Federal Reserve Act on November 16, 1977, was:

> To maintain the long-run growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.

Of course, all of this translates into good jobs. That's what leads to adequate consumer demand and a productive economy. The problem of course is that there is increasing rigidity about what maximum employment is defined as, and I am astonished looking back at what we thought was full employment in the 1960's to see that a 5 to 6 percent or even higher rate of unemployment is now considered acceptable, which brings along with it a 20 to 25 percent rate of child poverty and even higher in California.

Structurally the Board makes key regulatory decisions affecting the safety and soundness of taxpayer-backed deposit insurance

funds, and the Board has a critical say about what safeguards are enforced for consumers in the financial marketplace.

For low- and moderate-income and minority citizens the Fed's approach to the Community Reinvestment Act and Equal Credit Opportunity Act can be the difference between opportunity and despair for many people. I don't think most consumers realize what huge consumer responsibilities the Fed has that should never be corralled under the umbrella of secrecy and independence and the other shibboleths that the Fed has often arrogated to itself to avoid public accountability.

The Fed has plenary power to set standards for deceptive practices of banks since 1975, and it has not issued one single rule in that area, Mr. Chairman. It has of course rulemaking authority in Truth-in-Lending, Truth-in-Savings, the Equal Credit Opportunity Act, the Fair Credit Billing Act, Home Equity Lines of Credit, Electronic Funds Transfer, and the Home Mortgage Disclosure Act. Its rulemaking activity has been extremely minimal in these areas, and of course if you don't issue the rule you don't have very effective enforcement.

The independence of the Federal Reserve has become an article of faith to be intoned rather than a proposition to be examined. First of all, it has different functions, a monetary function, a consumer protection function, and a research function, and the rather hidden world of the way it operates without any paper trail to deal with such issues as the bailout of the Mexican Government.

There is an almost meta sphere between banking agencies and the Treasury Department here, Mr. Chairman, on areas that are not reduced to contractual arrangements, and they're not reduced to observable or accessible to-the-Congress documentation, and, unfortunately, the Chairman of the Federal Reserve rarely gets asked questions about that.

When Continental Illinois was about to go under and the discount window opened at the Federal Reserve we wanted to see what paper was behind the loans and what the rationale was for the bailout of Continental Illinois some years ago. It is almost impossible to get the paper, the documentation which indicates the meta-type law that is operating or non-law that is operating in these spheres.

And of course the claim of independence is a bit thin because the claim is directed toward the Congress, toward the President, and toward the American people. No one really can make a strong case that the Federal Reserve is independent of the banks and other large business establishments. So it's important to raise the issue that is presented when the Fed defends what it does and repulses official inquiries, not to mention civic inquiries by saying that it has to maintain its independence.

The word "independent" does not appear in the Federal Reserve Act, but the Federal Reserve has assumed it and given the word a new and powerful definition. Proposals to change the Federal Reserve Act and Board operating procedures and other policies are always greeted with sounds of alarm from the Federal Reserve and its apologists claiming a threat to independence of the agency. Any call for accountability, openness, and even simply giving the rationale for their Open Market Committee deliberations is interpreted

as a threat to its independence and as an attempt to exert political influence over its decision.

Let's face it, the Federal Reserve is an autocracy that remains so as long as it doesn't particularly upset the established powers. It is an autocracy unique in our American Government—keeping it from accountability to the Legislative branch, not to mention the Executive branch, and most importantly to the American people.

While the Federal Reserve may continue to parade its independence, we must recognize that it operates under a series of indicators and a series of definitions that are almost mocking the empirical reality of what's affecting the American people in terms of stagnant wages and declining real wages for the bulk of the working people in this country.

In the final analysis the Fed's independence is a shield against accountability. It shields the Fed from analysis of bad policy, outrageous mistakes, mismanagement and other problems. This so-called independence was never challenged even in the era when the Federal Reserve was presiding over an extremely deteriorating banking industry only a few years ago which required such ample Congressional bailouts.

The second aspect of the Federal Reserve is secrecy, which I go into in some detail here, and Senator Sarbanes has certainly properly made the point of the need to disclose the transcripts of the Fed Open Market Committee. They are now withheld for 5 years. So there is no way to judge the present Governors of the Federal Reserve, including the Chairman, on these decisions until 1998–1999 for the decisions to increase interest rates that were occurring in 1994 and early 1995. Even the transcripts, in the words of the Federal Reserve, are lightly edited. The full unedited transcripts are locked away for 30 years.

I do not believe that this Committee would accept the same secrecy from other agencies and departments under its jurisdiction and it would not tolerate hidden agendas and only vague sketches of policy decisions from the Department of Housing and Urban Development or the Securities and Exchange Commission. To tolerate it for the Federal Reserve would require the Federal Reserve to uphold a much greater burden of proof as to why business should continue as usual than has been tendered at hearings before the Senate Banking Committee.

I think that Senator Sarbanes' recommendations on trying to do something about the conflicts of interest here involving the Federal Reserve and its regional banks needs to be given far greater support here in the Congress.

Then you have Congressman Gonzalez who in early January issued some important disclosures about the Federal Reserve's contracts for overnight clearing and collection of checks. And it was his inquiry that uncovered the fact that full verbatim transcripts did exist of the Open Market Committee hearings.

Even with the tapings admitted, the Federal Reserve contended that many of the tapes had been taped over and there were no complete transcripts in existence. Ultimately the hide and seek game ended with a concession by Chairman Greenspan to Congressman Gonzalez that indeed the tapes existed and that 17 years of full transcripts were at the Federal Reserve.

Well, Congressman Gonzales has still not gotten an answer from the Fed for his detailed report on the Fed's check clearing operations submitted in early January.

Secrecy, as we all know, in Government is a kind of power and it should be seriously challenged and not simply accepted because that's the way things have always been with the Federal Reserve.

I might say as an anecdote, Mr. Chairman, when I was at Princeton University, and maybe Senator Sarbanes can corroborate that, when we had Economics 101 under Professor Chandler, who was on the Philadelphia Regional Board of the Fed, when it came time to study the Federal Reserve we were distributed free a 180-page booklet on the Federal Reserve. We learned about the Federal Reserve from this booklet, and it was of course produced by the Federal Reserve.

So the Fed, like Fannie Mae today, is exceptionally adroit in terms of how it develops and implements its narrow frame of reference and its rigid indicators, not just here, but through the educational system. Of course, being independent of any budgetary reliance on the Congress, it is also independent of any kind of scrutiny that proceeds from the appropriations mechanism.

I would like to move on to the consumer issues, and I have just outlined briefly how expansive the responsibilities of the Fed are in the consumer area. I am very glad to have heard Chairman Greenspan, and I never thought I would ever hear the words as he enunciated it this morning, that he thought in reference to the GAO: "It was very useful to have somebody look over your shoulder on a day-by-day basis."

I think certainly whatever restraints are here in Congress of inquiring into monetary policy practices, procedures and policy, there is no reason whatsoever for not examining its role in consumer protection, and I must say that a prime example of how the Fed is on the sidelines here was in the news last week when the Federal Trade Commission announced it was launching a major effort to fight scam artists who were using demand drafts to rob consumers' bank accounts of tens of millions of dollars annually.

The victims were consumers who had given out their bank account numbers and permission to use demand drafts for magazine subscriptions, various membership fees and similar outlets. To make the scams work obviously required wide utilization of the banking system, right where the Federal Reserve's authority lies. But it was left to the Federal Trade Commission, not the well-staffed and well-funded Federal Reserve System, to take aggressive action finally to protect the consumer even though the Federal Reserve shared identical enforcement power with the FTC under Section 18(F) of the FTC Act. When the contest over consumer regulations is between consumer and the banking industry the Fed can find some creative ways to support the industry.

The Congress, for example, recently asked the Federal Reserve to give it a report on regulations to limit the time that banks may hold checks before crediting the consumer's account. I might add I noticed that Chairman Greenspan thought it desirable for instantaneous settlements between business firms globally, but I would only hope that he could pay as much attention to more expeditious settlements when consumers are involved in the check hold matter.

Not only that, but as bank branches have been closed down in the hundreds, Mr. Chairman, we have the emergence, and something you know very well, in poor areas in New York City of check cashing stores and the horrible gouging that goes on there. Recently the head of a major insurance company called me up to complain about check cashing stores which refined my alert to a problem that has been too long ignored.

In answer to the Congressional request, the Federal Reserve decided to survey the banks and prepared a one-sided questionnaire that assures the results will be weighted to the bank's desire to lengthen the time they could hold people's checks. I explain that in my testimony.

The Fed's implementation of the Equal Credit Opportunity Act (ECOA) provides a good example of the Fed's regulatory inertia when it comes to consumer, community, and civil rights interests. Although ECOA prohibits credit discrimination against small business persons as well as consumers the Federal Reserve has never established any disclosure requirements that would permit monitoring of discrimination against small businesses. Now, I know you asked about this a few moments ago.

Indeed, the Fed's Regulation B which implements ECOA perversely prohibits lenders from collecting data on the distribution of their small business loans by race category. Civil rights groups, community groups, and even the Clinton Administration have asked the Fed to revise Regulation B, to require lenders to collect and make public race data on their business lending patterns. Under strong pressure from the Clinton Administration the Fed in April 1995 proposed to modify Regulation B to permit voluntary collection of race data on small business loans and other types of credit. Yet 1 year later the Board has failed to act on even this extremely modest proposal.

Similarly the Fed is looking the other way on the convenience and needs of communities. As mergers sweep across the Nation, neighborhoods and communities are facing the loss of banking facilities while borrowers in low- and moderate-income minority neighborhoods, already starved for credit, are seeing lending decisions moved through distant lines of management in these newly merged giants.

Eight hundred community organizations turned out on the West Coast recently to oppose the Wells Fargo/First Interstate merger on the grounds that the closure of 345 branches would severely wound local communities. The Fed heard the arguments and received the documentation, but in the end the wishes of Wells Fargo were granted and the 345 branches will be closed.

Mr. Chairman, interstate branching and the vast increase in mergers is creating a new generation of problems for communities, but the Federal Reserve is not meeting its responsibility to examine fully the convenience and needs of communities as required by the Bank Holding Company Act and the Bank Merger Act.

The final point I want to make is that dissent isn't allowed on the Greenspan Board. Dissent is very critical as a climate of regulatory and other decisional deliberation by Government agencies. Alan Blinder, the Vice Chairman appointed by President Clinton unexpectedly resigned and returned to his job at Princeton remov-

ing a voice from the Board for more openness and more concern about employment and consumer issues than may have been compatible with the Greenspan party line. There were published reports, including one in the Columbia Journalism Review, that Greenspan's staff had leaked unflattering remarks to the media that led to stories that Blinder was "soft on inflation," an episode that undoubtedly increased Blinder's frustration and desire to leave the Greenspan Board.

Take someone like Felix Rohatyn, who we interviewed extensively years ago for our book, "The Big Boys." Even he is considered too radical and too focused in the Blinder fashion on the full employment role, stimulatory role of the Federal Reserve. Someday the way that nomination was bungled will, I'm sure, come out in the reputable press. It does seem to me rather a serious attribute of the Federal Reserve that we get such reluctance on the part of members of the Board of Governors to disagree publicly even on issues that don't immediately ruffle the money markets. The pressure for consensus, and the pressure for unanimity is facilitated by the absence of disclosure of the transcripts, for example, of the Open Market Committee.

In conclusion, I did point to a number of areas that were never brought to the nomination hearing process involving Chairman Greenspan's poor judgment in dealing with his clients when he was in private life as a consultant. He was a consultant to a number of savings and loan associations, including the ill-fated Lincoln Savings and Loan which he stated publicly, at exactly the worst time, that Lincoln Savings, "was a financially strong institution that presents no foreseeable risk to the Federal Savings and Loan Insurance Corporation," in a letter of February 13, 1985, to the principal supervisory agent of the Federal Home Loan Bank of San Francisco.

These and other episodes in Mr. Greenspan's background make it all the more important for the Congress to weigh in more heavily to make sure he and his colleagues pay more attention to the effect of the Federal Reserve on consumer protection and to the effect of the Federal Reserve on dealing with the imperatives of modern technology that are working against consumers, to look at the bank charges and fees and the unbundling of the consumer's bank statements these days, and, of course, to the effect of monetary policy on labor.

It would also be interesting to know where the Federal Reserve Chairman stands on the decision of the Federal Deposit Insurance Corporation to cap the reserves of the Bank Insurance Fund and allow the majority of banks to pay no premiums for Government insurance.

Mr. Chairman, I don't think a $25 billion fund is an adequate fund for any contingencies given the large size of banks today and the likelihood that one or more of them is going to get in deep trouble and could easily absorb that amount. When banks are making a lot of profit is exactly the time they should pay into the insurance fund. When they do get in trouble, if there is a cyclical downturn and the insurance fund is exhausted, we are not going to be politically able as a Nation to tap the banks to fill those insurance funds—and the taxpayer will have to pay for the bailout, just as

the taxpayer has paid for the bailout of the Mexican oligarchy and its corrupt regime.

It is important, finally, for this Committee to insist on changes at the Federal Reserve as a condition for confirmation, particularly changes that would remove some of the thick walls of secrecy that separate the agency from the people and the Congress. Let us remember if Alan Greenspan is confirmed, as he probably will be overwhelmingly, he will control the Federal Reserve into the Year 2000.

About all that can be said about that is it will give the Congress a few more years to develop more specific frames of reference to evaluate the Federal Reserve, to demand more specific disclosures of rationale, and above all to expand the definition of market indicators to reflect the empirical reality that they now do not reflect, and that is what characterizes their lack of humanity and their lack of sensitivity to what millions of workers in this country know is going on, and that is the downsizing of the middle class.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sarbanes wishes to make a comment.

Senator SARBANES. Mr. Chairman, I have another engagement which I should have been at quite some time ago, but I simply want to say that obviously a great deal of thought and work has gone into this statement which Mr. Nader has submitted for the Committee, and I want to thank him for that work. There are a number of points in here which I think attention needs to be given. In fact, I asked about some of these points in the course of the previous panel as it just turned out, and I just wanted to thank him.

Mr. NADER. Thank you, Senator Sarbanes. I might add that if you or the Chairman want more information my colleagues Jon Brown and Jake Lewis would be very happy to go into greater detail.

The CHAIRMAN. Let me, if I might, touch on what I think is the centerpoint of your concern about the operation of the Fed and its claim that there is a need, and indeed I think many have echoed this, for independence, particularly as it relates to the question of monetary policy. Do you have any trouble with that theory, or the theory advanced and held by many, that in order to keep the Fed from acting in a very political manner, whether it be as a result of the Congress or the Executive, that there be a certain degree of independence?

Mr. NADER. Yes, a certain degree, and of course that is what the debate is about. Let's separate the issues here. How much should independence preclude you, as a Senator, from finding out what the Federal Reserve did 1 year ago or 5 years ago or 10 years ago on monetary policy? There is a long statute of limitation operating here before secrecy is waived.

The CHAIRMAN. So you're not contending, for example, that the minutes from one Open Market Committee meeting be made available in the interim before the next meeting is held? I know you were here and heard the Chairman respond to that question as to why the minutes of the preceding meeting not be released, and I think he gave a reasonable explanation. Is that an area, for example, that you would disagree with him?

Mr. NADER. Yes, because the objection that he gave could be neatly excised from the minutes. When I heard that one of my colleagues said well that doesn't mean all of it has to be deferred in terms of disclosure. There are some super-sensitive parts that can be excised, but not the entire transcript.

The CHAIRMAN. Let me ask you this. What would be the harm if the minutes were made available after the next Open Market meeting? In other words, I am trying to look at this and get to this in a manner which would encourage more openness. And recognize that once we begin going down a certain path it is irresistible for those in Government, whether it is the Legislative side or the Executive side, to act with restraint. They seem to want more and more power, and then it does become a power grab. Are you necessarily opposed to the release of the information after the second meeting?

Mr. NADER. The problem is if you release it after the second meeting you reduce the timeliness of the opportunity for the public and Congress to analyze what they did in the first meeting before the second meeting occurred, and you reduce the interest. The very interest in it becomes obsolete. I think the reliance of the markets on every single word and phrase of the Chairman is unhealthy, and I think he would be the first to agree.

The CHAIRMAN. We have seen the overreaction in the marketplace, and it has been something that has been I think historical. I remember when Paul Volker would come in and talk about or even mention the money supply and there would be a mad dash out of this room, and you didn't want to get caught at the door with the reporters racing to put over the wires what had taken place. The gyrations in the marketplace were incredible. I happen to think that that was a very unhealthy kind of presentation, and of course I think that in many cases there was a total overreaction. You would see a drop of 30 or 40 or 50 points in the market, and 2 days later the market would come back up. On many occasions when the Chairman made these kinds of announcements as to whether or not they hit their target, I thought too much emphasis was placed on it, and that emphasis was very unhealthy.

You see, I do believe that we should have, and I think it enures to the credit of the Chairman, better oversight in a number of areas. I am particularly concerned with respect to policies that do not involve the day-to-day activities of the marketplace and would not create consternation, after a reasonable period of time, to have the information be made available. For policies which involve billions of dollars of taxpayers' money, whether it's through the IMF or to foreign countries, and Mexico is one of those that comes to mind, it just seems to me that there should be some form of accountability to the people of this country that does not become intrusive and does not have Congress attempting to second-guess.

If you subscribe to the philosophy that we should not have the independence over our monetary policy threatened by undo interference or interference by the Congress or the President, then how would you achieve a balance if you think that's an objective that has to be maintained?

Mr. NADER. First of all, if we're going to preserve monetary policy from undo interference by Congress or the White House we should preserve it from undo interference by the banking industry

and by the corporate executives and bankers who are on the Regional Boards of the Federal Reserve and the conflicts of interest are ripe. So let's at least try to be consistent on that. I don't think the Federal Reserve is as independent of the banking and corporate community as it is of the Congress and the President.

Second, I would demark the area where there is the greatest insistence here on Capital Hill of independence for the Federal Reserve and treat the rest of it like any ordinary regulatory agency.

The CHAIRMAN. So you're willing to concede that maybe there would be some kind of a demarcation?

Mr. NADER. Right, but narrowly drawn.

The CHAIRMAN. One area would be maintained and be, and I don't like to use this word, but it's the best one that I have at hand, independent or off limits to the Government. Obviously we have a right to say what we want, but not to be able to effectuate that is another matter, and to maintain that independence but then have clear oversight and responsibilities into other areas.

Mr. NADER. But always keeping in mind that we still must have greater public understanding of the role of money in our society and the role of the Federal Reserve, and whatever is forbidden tends to provoke conspiratorial theories around the country about the Federal Reserve, and there is insufficient public debate and discussion compared to the 1890's in our country when ordinary folk discussed the gold standard and the silver standard in ways that most people in this country now would not understand.

So even within monetary policy if there is going to be an independence it should be not only to the public sector here on Capitol Hill and the White House, but the private corporate sector as well, and I hope Senator Sarbanes' proposal on conflict of interest reform is given greater attention.

But I would also point to an area that you have tried to probe during this Mexican bailout situation a while back. There is too much that the Federal Reserve does that is straight out political, and there is nothing more political than the Administration's bailout of the Mexican oligarchy and its corrupt regime, and it got its hands quite deep in it, and I have it on reasonably good authority that Paul Volker was quite upset, and he may deny this, but that he's quite upset that the Fed got so deep into the political negotiating and wheeling and dealing processes behind closed doors relating to the Mexican bailout.

So that's a whole area that to me is almost the most extensive arena of unbridled Government discretion in our history. I mean the Executive Privilege invocation by the White House over the years is tame compared to the unbridled discretion that the Fed has had in so many areas. That means there is no rule of law, and that means there is no accountability, but more basically there is no public understanding to evaluate this bureaucratic beast, so to speak.

The CHAIRMAN. Can I take you into another area? I know you came to testify with specificity and I want to address that before we close the hearing.

I believe that you're absolutely deeply concerned about the problems of our inner cities, about the problems of underemployment and about the problems of lack of job creation. It seems to me that

one of the areas in which we can do a great deal, although there are some abuses, is the giving of tax credits for people at certain income levels to encourage people to become part of that economic system. It's one thing to say that we will give you an opportunity, and then the people don't really have an economic opportunity and it's just lip service, and I tell you it's probably the single reason that I voted for that horrible 1986 tax bill. I mean it was just a horrible bill, and it was one filled with retribution, I won't get into it, but I recall very vividly some comments that I didn't feel were justified.

So that's taking it at a certain level saying that people can earn up to a certain level and be permitted to keep the fruits of their labor, but it also seems to me that there may be trillions of dollars that are locked up because of undue capital gains taxes.

Have you considered what the impact might be on bringing more capital into the marketplace by lowering the rates or eliminating capital gains taxes? I don't know if you've considered that. I'm not going to press you for an answer, but if you would like to, I would be interested in your response. If you haven't looked into it, I would be interested in your sharing that with me.

Mr. NADER. The principal area of tax waivers for poor areas in our country historically has been Puerto Rico. Going back to when I went down there back in the 1950's and my modest familiarity with the situation until now, it hasn't worked very well and there is massive unemployment.

The CHAIRMAN. It has been abused, too, in certain cases.

Mr. NADER. Abused, massive unemployment and if it wasn't for the exodus of Puerto Ricans to the mainland it would be even worse, not to mention the terrible pollution problems.

Here is what I think has worked in other poor areas and not just in the United States. The key is providing credit and capital to indigenous entrepreneurs who live there and who are going to build job-intensive businesses. That requires a semblance of law and order of course, a physical security in these areas, but the idea of getting one big plant into a large area where the underclass live with a tax break is just more Puerto Rico all over again. It has also a lot of instability accorded to it.

Imagine the poor workers in Puerto Rico when they hear Members of Congress say they want to get rid of the tax break for companies that go to Puerto Rico. They're very much strapped.

Have you heard about this little bank I think in Bangladesh which loans small amounts of money to women that has been so spectacularly successful?

The CHAIRMAN. Yes.

Mr. NADER. Well, on a large scale if the Fed through its research and through a heightened sensitivity would pay attention to how it could develop loan/loss reserve funds the way Michigan is experimenting with to get the capital and credit into the poor areas and other ways of providing capital and credit I think it could perform a great service. I'm not that impressed by the tax expenditure.

The CHAIRMAN. Then you don't think capital gains tax cuts are the answer?

Mr. NADER. No. Even to the extent it works it is absentee ownership and it can be pulled out by other venue that gives them dif-

ferent kinds of corporate breaks or welfare. What you want is not only job producing businesses in the poor areas, but you want the neighborhood itself with all the collateral development to revive once again.

The CHAIRMAN. I am impressed by your observation, and I think it is an absolute reality and truism, that absent public safety and security you can't make it, whether it is in business, whether it is in school, or whatever it is. That is an absolute essential ingredient for any hope of success.

Mr. NADER. That's right. You can have the desire, but if you don't have the water, and the water is in effect the physical security of these neighborhoods it isn't going to work.

The CHAIRMAN. Let me say this, I am going to ask our staff to meet with the colleagues that you've suggested in attempting to develop those areas where we might, and I guess this would be very, very provocative but I'm kind of used to that, want greater accountability and those areas where there is no question that we would not want to interfere with monetary policy. We do not want a situation where Congress or the President decide to jack up the interest rates or drop them down to score political points, et cetera, because we want to recognize that there are areas where we should be concerned about political influence.

I also want to say that I think that you have brought to us some very valid concerns. We will look at them because I do believe we have to exercise proper oversight, not to be intrusive and not to have a power grab because that is not our intent.

And last, but not least, I am wondering if you might want to consider how we could work to enhance credit opportunities particularly to small businesses both in distressed and nondistressed areas. I am interested in this area and sponsored the securitization of loans for small businesses. We haven't gotten a study, and we should be able to get that information fairly easily, as to where securitization has been effective and whether banks are involved because the marketplace takes time to adjust.

But I am very much concerned that there is not an adequate capital flow into distressed economic areas and into small business communities. I recognize that if we fail to provide public safety in these areas there is not going to be capital flow. As a person who cares deeply about a community, you wouldn't try to invest in an area where you saw that that business would have no chance of surviving. It just seems to me that this is one of the areas that we just really have to do more and do a better job without political grandstanding.

Mr. NADER. I think your concern earlier to Chairman Greenspan was not adequately responded to by the Chairman about the effect of mergers reducing loans to small businesses. Jon Brown can provide a very careful critique of the Chairman's response if you would like it, but I would just like to make this point.

When small business works with smaller banks there is a whole pattern of relationships that buildup. They're not all quantified and monetized the way the big banks do when they decide who gets it and who doesn't. Character, confidence, knowledge of the families, et cetera, that has been severely impaired by the merger wave that has been going on.

The CHAIRMAN. Have you examined at all the necessity to continue providing Federal deposit insurance in the manner in which we do it now?

Mr. NADER. Yes. Without going into any detail, we have made observations about how it provided too much of an incentive for the capital pools in the savings and loan crisis and how it's extremely risky to in effect cap that fund at $25 billion at a time of spectacular problems.

The CHAIRMAN. Well, let me ask you this. Have you thought about eliminating the insurance, except for limited amounts, and returning to maybe the $20–$25 thousand or $50 thousand per individual limit, and I don't mean at an individual institution, but throughout the system. You would probably have to charge a minimal amount because the institution would then be in a position of acting as a broker because you would be restricted to investing in Federally-insured instruments. This would give the people a guarantee, those who did not have the capacity to buy Treasury securities, and the bank could make a small service charge for handling that. Now some people in the industry may not be happy, although I hear everybody tell me they want competition. They don't want Federal regulation, et cetera.

Why should the Federal Government be insuring, and not only billions, but trillions of dollars worth of business activity that it has very little control over and place taxpayers' money at risk?

Mr. NADER. First, I think it should have some control attendant to its insurance function. I think it is a recognition that bankers can get out of control. They get too greedy, too risky, and too speculative and damage a lot of innocent people in the process.

The CHAIRMAN. How do you supervise it? What I am saying is I think it is impossible to supervise adequately given the risk attendant and given the technological developments that have taken place and continue to take place and the different kinds of instruments, et cetera.

Mr. NADER. Well, one is given the S&L experience—it is the old fashioned supervision of crooks. I mean they were just crooks, the heads of these banks who behaved in the old fashioned way of crime, and that was not prevented by the Federal or the State banking agencies. They knew what was coming, but they looked the other way, as well, by the way, as did the Board of Directors, the outside law firms, and the outside accounting firms.

Second, you could have risk weighted insurance functions. There is a principal concern I have about getting rid of Federal insurance all together, and that is it will reduce the ability of new entries into the banking business. I think the fact that a new bank could start with that insurance of the FDIC allowed some new entries, and maybe that's not even a worry any more, and maybe we're going to end up with eight giant mega-bank corporations, but there is a question of the stimulus to competition, new entries, when you have a Federal deposit guaranteed system.

The CHAIRMAN. Maybe you'll take a look at it.

Mr. NADER. Sure.

The CHAIRMAN. I mean we're going to examine it. I think we owe it to the people, I think we owe it to the Committee, and I think we owe it to the industry to do that, to take a comprehensive look

at what role, and I'm not suggesting we're going to eliminate it entirely, but what role should deposit insurance play. Should it be restricted to certain kinds of institutions that will be limited in terms of the investments they can make? Why should we be insuring all kinds of activities that the regulators themselves have very little, if any, experience with, derivatives, et cetera. One of these days we may walk into a situation where we find out that there are some serious problems.

Mr. NADER. The problem is as long as you have this too big to fail unwritten policy of the Federal Government if these banks misbehave and aren't prudently controlled through any kind of insurance function or auditing function and they're big enough, is there anybody bold enough to say that the taxpayer will not be forced to bail them out?

The CHAIRMAN. That's a legitimate question, and, second, even with the most prudent oversight today given the complexity and the magnitude of some of these transactions are we able to adequately supervise these transactions?

Mr. NADER. Here is where I come with my final suggestion. When the savings and loan bailouts were first being proposed in the Congress, you were here, it was thought about $50 billion a year that would be needed. Some of us proposed that to prevent this from happening again that the savings and loans, since they had such a Federal backup and bailout, be required to put an insert in their envelope at no cost to themselves and no extra postage which would invite financial consumers to band together in what are called Financial Consumer Associations (FCA's). Congressman Schumer championed this early on. Here is how this would work. Bank customers would get this insert periodically in their bank statement. If they wanted to they would fill out a coupon and send in $5 or $10 or whatever the annual dues were, have a vote to elect the Council Directors of this Statewide Financial Consumer Association which would hire a full-time staff, not just to watchdog, but also to negotiate with the banks and also to provide more information to consumers about all of these different laws and protections such as equal credit opportunity and Truth-in-Savings.

I was very, very upset when there was such a poor response, six Members of the House Banking Committee supported this, because it doesn't cost the taxpayer anything, it's voluntary to the consumer and it's universally accessible, and it redresses that imbalance between the banks and the unorganized customers, especially nonbusiness customers. Yet the taxpayers who had nothing to do with this savings and loan debacle were forced over a period of 25 years to pay half a trillion dollars in principal and interest.

Once you develop a community intelligence back home where a sufficient number belong, this idea can work for the people. I am waiving this insert in front of you because this comes from Illinois where, in the residential ratepayer area, this was done in 1983 for electric, telephone, and gas companies in the billing envelopes and in later years it is included in State government mailings. It has worked beautifully. The consumer is represented by competent staff, there are 200,000 members of the Illinois Citizen Utility Board and they joined voluntarily and have a $1.5 million budget.

Just to give you one example of their victory, in September 1993 they privately negotiated a $1.3 billion refund from Commonwealth Edison for overcharging the residents of Northern Illinois in terms of excessive capacity of their nuclear power plants, which they charged to the consumer instead of to their investor. In areas of telecommunications, gas pipelines, electricity there is someone there for the consumer. There is a watchdog. It's not just an easy idea, but such a powerful one, and it's not regulation. It's just facilitating and making it easier for financial consumer associations to band together. Your good friend, the former Governor Mario Cuomo was a supporter of that.

The CHAIRMAN. Let me tell you, he should have been thinking about the bailout of LILCO with $6 billion that the taxpayers and ratepayers got stuck paying which is making our Island an economic wasteland with the highest utility rates in the country. If you want to talk about a bailout, we bailed out the stockholders, we bailed out the bondholders and we absolutely drowned the ratepayers of Long Island. This is about as bad as the Mexican situation. People buy stock and they buy bonds and they build this plant, $6 billion. They come and say, no, you can't open it. All right. It seems to me that if you bought stock in it and you have bonds in it the ratepayers shouldn't now be called to pay for this plant that was never operated. Incredible.

Mr. NADER. I submit that if you had these kinds of associations it would have been better for you.

The CHAIRMAN. I only got into that because you know who the architect of that was. That was Governor Cuomo. Now I have to tell you that I think our State Legislature went along with him, and the Public Service Commission, where were they? They actually went along with this thing, too. There was no public representation there. I think we ought to get a Nader lawsuit going.

[Laughter.]

I mean I don't know if the statute of limitations has run. I'll have to check that out.

Seriously, I want to thank you for coming in and for making us aware of your concerns and the manner in which you attempted to deal with some of the issues that you brought forth.

We stand in recess.

[Whereupon, at 2:52 p.m., the Committee adjourned, subject to the call of the Chair.]

[Prepared statements, biographical sketches, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman, thank you for the opportunity to gather insight from these well-respected economists and Federal Reserve Board nominees. I believe President Clinton has done himself a favor by nominating Laurence Meyer and Alice Rivlin. I also believe the renomination of Alan Greenspan as Chairman of the Federal Reserve is imperative to the continuity of monetary policy and certainty of financial markets.

I continue to believe the best monetary policy a country can have is one that strives for price stability and zero inflation. Inflation is a tax plain and simple. Americans are taxed too much already and should not have the purchasing power of their dollar stolen from them. Hard working Americans deserve to bear the fruits of their labor, and a strong, sound, independent bank is essential to that goal.

Lately, the Federal Reserve has been criticized for not being accountable to Congress. Some Members have even suggested we politicize the Federal Reserve Bank. Let me say that I believe that would be the biggest mistake we could ever make. Congress and the President cannot even agree on a balanced budget deal, much less the rate of growth of monetary aggregates or the correct Federal funds rate. Monetary policy should not be subject to the whims of the political cycle. Without qualification, the Federal Reserve Bank should maintain its independence.

Last, I want to say that I was intrigued by Chairman Greenspan's recent testimony on the Hill. In particular, I enjoyed his comments on increasing the growth potential of the U.S. economy. At a time of job insecurity and less than promising economic expansion, I look forward to talking with the nominees and gathering their insights on how to best increase the noninflationary growth potential for the United States.

Thank you Mr. Chairman.

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name:	RIVLIN, ALICE MITCHELL
Position to which nominated:	Member & Vice Chair, Federal Reserve Board
Date of nomination:	March 15, 1996
Date of birth:	4 March 1931
Place of birth:	Philadelphia, Pennsylvania
Marital status:	Married
Full name/Spouse:	Sidney Graham Winter
Name and ages of children:	Catherine Amy Rivlin, 39 Allan Mitchell Rivlin, 37 Douglas Gray Rivlin, 32

Education:	**Institution**	**Dates Attended**	**Degrees Received**	**Dates of Degrees**
	Radcliffe College	1953-57	Ph.D/Economics	1958
			M.A./Economics	1955
	Bryn Mawr College	1948-52	B.A./Economics	1952
	Madeira School	1944-46		
	University School	1946-47		
	Madeira School	1947-48	High Sch Diploma	1948

Honors and Awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

1983-87:	MacArthur Foundation Prize Fellowship
1984:	LLD, Yale University
1984:	Harvard University's Godkin Lecturer
1976:	Doctor of Science, University of Indiana
1975:	LLD, University of Maryland
1975:	LLD, University of Michigan

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Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	**Office held (if any)**
American Economic Association	Member (National President, Vice President, Member of Executive Committee)
Committee for A Responsible Federal Budget	Director
Congressional Budget Office	Panel of Economic Advisers
Council on Foreign Relations	Member, Director
Eugene and Agnes E. Meyer Foundation	Director
Madeira School Alumnae Assoc.	Member
Bryn Mawr Club of Washington	Member
Radcliffe Club of Washington	Member
TJ International	Director
Union Carbide Corporation	Director
Unisys Corporation	Director
The Wilderness Society	Member, Chair, Governing Council
The Los Angeles Times Board Of Economists	Member
Time Board of Economists	Member

Newspaper Columnist: The
Washington Post, New York Times,
Atlanta Constitution, other papers
and magazines

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

10/94 - Present:	Director, Office of Management and Budget, Washington, D.C.
1/93-10/94:	Deputy Director, Office of Management and Budget, Washington, D.C.
1/92-1/93:	Hirst Professor of Public Policy, George Mason University, Fairfax, VA (on leave Brookings Institution)
1987-1/93	Senior Fellow, Economic Studies Brookings Institution, Washington, D.C.
Spring Semester 1988:	Visiting Professor, John F. Kennedy School of Government, Harvard University, Cambridge, MA
1983-87:	Director, Economic Studies, Brookings Institution, Washington, D.C.
1975-83:	Director, Congressional Budget Office, Washington, D.C.
1969-75:	Senior Fellow, Economic Studies Program, Brookings Institution, Washington, D.C.
1971:	Editorial Writer, The Washington Post (4 months leave from Brookings Institution)
1968-69:	Assistant Secretary for Planning and Evaluation, U.S. Department of Health, Education and Welfare, Washington, D.C.
1966-68:	Deputy Assistant Secretary for Program Coordination, U.S. Department of Health, Education and Welfare, Washington, D.C.
1958-66:	Economist, Economic Studies Program, Brookings Institution, Washington, D.C.
1961-62:	Staff Member, Advisory Commission on Intergovernmental Relations (on leave from Brookings Institution)

1957-58:	Research Fellow, Economic Studies Program, Brookings Institution, Washington, D.C.
1954-57:	Teaching Fellow and Tutor in Economics, Harvard University, Cambridge, MA
1952-53:	Research Assistant, U.S. Mutual Security Agency, Paris, France

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

1994-present:	Director, Office of Management and Budget
1993-94:	Deputy Director, Office of Managment and Budget
1989-90:	Chair, Commission on Budget and Financial Priorities of the District of Columbia
1983-92:	Panel of Economic Advisers, Congressional Budget Office
1975-83:	Director, Congressional Budget Office
1968-69:	Assistant Secretary for Planning and Evaluation, U.S. Department of Health, Education and Welfare
1966-68:	Deputy Assistant Secretary for Program Coordination, U.S. Department of Health, Eduation and Welfare
1961-62:	Staff Member, Advisory Commission on Intergovernmental Relations (on leave from Brookings Institution)

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

See Appendix 1

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Occasional consultation on issues with Clinton Campaign, 1992.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

1988:	
Democratic Victory Fund (Dukakis campaign)	$1,000.00
1989:	
Emily's List	500.00
1990:	
Emily's List	1,000.00
Josie Heath for Senate (Colorado)	500.00
Hoosiers for Long (Indiana)	500.00
Bellamy for the '90's (New York)	500.00
Jolene Unsoeld Campaign	500.00
Sandy Scofield for Congress	500.00
Friends of Senator Carl Levin	1,000.00
1991:	
Citizens for Eleanor Holmes Norton	500.00
Jim Hunt Committee	500.00
Citizens for Senator Wofford	500.00
Wholey for State Legislature	500.00
Yrun for Congress Committee	500.00
Mikulski for Senate	500.00
1992:	
Democratic National Committee	1,000.00
Emily's List	3,000.00
Levin for Congress	500.00
Owens for Senate Committee	500.00
Yeakel for Senate	500.00
Eshoo for Congress	500.00
Boxer for Senate	500.00
1993:	
Democrats 2000	1,000.00

Terry for Governor (MarySue Terry, VA)	500.00
Emily's List	1,000.00

1994:

Emily's List	1,000.00
Citizens for Wofford	500.00

1995:

Emily's List	1,000.00
Minnick for Senate	1,000.00 (Idaho)
Clinton-Gore Campaign	1,000.00

Qualifications: State fully your qualifications to serve in the position to which you have been named.

I believe I am well qualified to serve as the Vice Chair of the Federal Reserve Board of Governors by virtue of my training, experience, and deep commitment to strengthening the American economy and making public institutions work more effectively.

I was trained as an economist and have focused my attention over four decades on public policy issues at the national level. For part of that time. I did research and policy analysis - or directed others doing such research and analysis - at the Brookings Institution in Washington, a public policy "Think Tank". There I dealt with fiscal and monetary policy, budget process, international trade matters, investment in human resources, health care, and a wide range of other issues. I did studies, wrote books, and interacted with the academic and policy communities in Washington. I also served on the boards of directors of several major corporations, one regional bank, and several non profit organizations.

I have also served in the Federal government several times in difference capacities. I helped set up the policy/planning staff at the Department of Health, Education, and Welfare in the late 1960's, serving as Assistant Secretary for Planning and Evaluation. In 1975, I was asked by the U.S. Congress to be the first Director of the newly created Congressional Budget Office. I worked with the Budget Committees and the leadership of Congress to figure out what that office should do and how to do it. I hired a staff to produce the analysis that the Congress needed to make better budget and economic decisions. We created a strong, credible and respected economic institution, of which I remain extremely proud.

Since January 1993, I have served President Clinton at the Office of Management and Budget, first as the Deputy Director and then as the Director. In that capacity I have helped the President make budget proposals and manage the government more effectively. It has been a

difficult period for budget policy, but I am proud of the Administration's record of deficit reduction and improved functioning of the federal government.

My years of work on fiscal and budget policy have reinforced my understand of the Federal Reserve as a crucial institution in enhancing the strength and stability of the American economy. If confirmed by the Senate, I would look forward to making a contribution to the decisions and activities of the Federal Reserve Board.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

   My present employer is the U.S. Government. I have already severed all business connections.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

   No.

3. Has anybody made you a commitment to a job after you leave government?

   No.

4. Do you expect to serve the full term for which you have been appointed?

   Yes

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

   None.

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

   None.

3. Describe any business relationship, dealing or financial transaction (other than taxpaying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any constitute or result in a possible conflict of interest with the position to which you have been nominated.

   None.

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

   As Director of the Office of Management and Budget, I have engaged in discussions with members and staff to explain and promote the President's program.

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

   Any potential conflicts that arise will be resolved through recusal or other appropriate action. I have established a qualified diversified blind trust and I have divested all assets that could pose a conflict.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

   None.

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

   None.

PUBLICATIONS

BOOKS

Reviving the American Dream: The Economy, the States and the Federal Government, Washington, D.C.: The Brookings Institution, 1992.

Caring for the Disabled Elderly: Who Will Pay? (with Joshua Wiener), Washington, D.C.: The Brookings Institution, 1988.

Economic Choices 1987 (with Henry J. Aaron, Harvey Galper, Joseph A. Pechman, George L. Perry, Charles L. Schultze), Washington, D.C.: The Brookings Institution, 1987.

The Swedish Economy (co-editor with Barry P. Bosworth), Washington, D.C.: The Brookings Institution, 1987.

Economic Choices 1984 (editor and contributor), Washington, D.C.: The Brookings Institution, 1983.

Ethical and Legal Issues of Social Experimentation (co-editor with Michael Timpane), Washington, D.C.: The Brookings Institution, 1975.

Planned Variation in Education: Should We Give Up or Try Harder? (co-editor with Michael Timpane), Washington, D.C.: The Brookings Institution, 1975.

Setting National Priorities: The 1974 Budget (with Charles L. Schultze, Edward R. Fried, Nancy H. Teeters), Washington, D.C.: The Brookings Institution, 1973.

New approaches to Public Decision-Making, Canada: Economic Council of Canada, 1972.

Setting National Priorities: The 1973 Budget (with Charles L. Schultze, Edward R. Fried, Nancy H. Teeters), Washington, D.C.: The Brookings Institution, 1972.

Setting National Priorities: The 1972 Budget (with Charles L. Schultze, Edward R. Fried, Nancy H. Teeters), Washington, D.C.: The Brookings Institution, 1971.

Systematic Thinking for Social Action, Washington, D.C.: The Brookings Institution, 1971.

The U.S. Balance of Payments in 1968 (with Walter Salant and others), Washington, D.C.: The Brookings Institution, 1963.

Measures of State and Local Fiscal Capacity and Tax Effort (with Susan Mushkin), U.S. Advisory Commission on Intergovernmental Relations, 1962.

Microanalysis of Socioeconomics Systems: A Simulation Study (with Guy Orcutt and others), Harpers, 1961.

The Role of the Federal Government in Financing Higher Education, Washington, D.C.: The Brookings Institution, 1961.

SUPERVISED PREPARATION OF...

Financing the Nation's Capital (The Report of the Commission on Budget and Financial Priorities of the District of Columbia), November 1990.

Numerous reports of the Congressional Budget Office, 1975-83.

Toward a Long-Range Plan for Federal Financial Support for Higher Education (U.S. Department of Health, Education and Welfare), January 1969.

Toward a Social Report (U.S. Department of Health, Education, and Welfare), February 1969.

Medical Care Prices, A Report to the President (U.S. Department of Health, Education, and Welfare), February 1967.

SELECTED ARTICLES, PAPERS, ETC.

"Beyond Alliances: Global Security Through Focused Partnerships" (with General David C. Jones (USAF, Ret.) and General Edward C. Meyer (USA, Ret.). A Study Funded by the John D. and Catherine T. MacArthur Foundation and the Rockefeller Foundation. October 1990.

"Simulating Policy alternatives for Long-Term Care: An Example of the Orcutt Approach," Journal of Economic Behavior and Organization, Vol. 14, No. 1, September 1990.

"Understanding Economic Policy: A Citizen's Handbook" (with Carol G. Cox), Washington, D.C.: League of Women Voters Education Fund, 1990.

"The Case for Common Shared Taxes," NTA Forum, Fall 1990.

"Wanted: A New State-Level Tax to Prepare Us for the 21st Century," A Commentary, Governing, April 1990.

"The Continuing Search for a Popular Tax," The American Economic Review Vol. 79, No. 2, May 1989.

"Insuring Long-Term Care," (with Joshua M. Wiener). George L. Maddox and M. Powell Lawton, eds., Annual Review of Gerontology and Geriatrics, Vol. 8, 1988.

"Economic Policy," (with Paul H. O'Neill, W. Michael Blumenthal and James D. Robinson, III), American Agenda: Report to the Forty-First President of the United States of America, Washington, D.C.: America Agenda, Incorporated.

"Who Should Pay for Long-Term Care for the Elderly?" The Brookings Bulletin, Vol 6, No. 3, Summer 1988.

"Systematic Analysis of Defense Issues: The Role of the Congress," Naval War College Review, Vol. XLI, No. 4, Seq. 324, Autumn 1988.

"Economics and the Political Process," (Presidential address delivered at the ninety-ninth meeting of the American Economic Association, December 29, 1986, New Orleans, Louisiana), The American Economic Review, Vol. 77, No. 1, March 1987.

"The Tax Reform Act," The Senior Economist, Vol. 2, No. 2, Spring 1987.

"Unsnarling the Process: Seven Ways to Improve Economic Policymaking," Public Welfare, Vol. 45, No. 3, Summer 1987.

"The Need for a Better Budget Process," The Brookings Bulletin, Vol. 4, No. 3, Summer 1986.

"Thoughts on Public Expenditures," Eastern Economic Journal, Vol. XI, No. 1, January-April 1985.

"Reform of the Budget Process," The American Economic Review, May 1984; available as the Brookings Institution General Series Reprint No. 402.

"Why and How to Cut the Deficit," The Brookings Bulletin, Vol. 2, No. 4, Summer 1984.

"The Political Economy of Budget Choices: A View from Congress," The American Economic Review, May 1982.

"Income Distribution--Can Economists Help?" The American Economic Review, May 1975; available as the Brookings Institution General Series Reprint No. 307.

"How Can Experiments Be More Useful?" The American Economic Review, May 1974; available as the Brookings Institution General Series Reprint No. 290.

"Social Policy: Alternate Strategies for the Federal Government." Presented and published as Woytinsky Lecture No. 3. Michigan: The University of Michigan, 1973; available as Brookings Institution General Series Reprint No. 288.

"Experimentation in Urban Education" (Spaulding Lecture delivered March 1971), Issues in Urban Education, New Haven, Connecticut: Yale University, 1972.

"New Approaches to Public Decision-Making," Special Study No. 18 prepared for the Economic Council of Canada, January 1972.

"Why Can't We Get Things Done?" The Brookings Bulletin, Vol. 9, No. 2, Spring 1972.

"Rethinking The Role of the Federal Government in Elementary and Secondary Education for the Seventies," with Robert W. Hartmanm Needs of Elementary and Secondary Education for the Seventies, Washington, D.C.: U.S. House Committee on Education and Labor, March 1970.

"Growth and Change in Higher Education," with June O'Neill, Proceedings of the Academy of Political Science, Spring 1970.

"Education, Politics, and Federal Aid," The Progressive, October 1970.

"Social Goals and Federal Support of Higher Education: The Implications of Various Strategies," with Jeffrey H. Weiss, U.S. Joint Economic committee, Compendium of Papers on The Economics of Higher Education in the United States, 1969.

"The Planning, Programming, and Budgeting System in the Department of Health, Education, and Welfare: Some Lessons from Experience," Subcommittee on Economy in Government of the U.S. Joint Economic Committee, 91st Congress, 1st Session, Compendium of Papers on the Analysis and Evaluation of Public Expenditures: The PPB System, (Vol. 3, Pt. V, 1969); available as the Brookings Institution Reprint No. 162.

"Population Growth and the American Economy," F.X. Quinn (ed.) Population Ethics, Corpus Books, 1968.

"Privacy, Poverty, and Old Age," with John C. Beresford, Demography, Vol. 3., No. 1., 1966. Reprinted in Jeffrey K. Hadden and Marie L. Borgatta, Editors, Marriage and the Family: A Comprehensive Reader, F.E. Peacock Publishers Inc., 1969.

"Critical Issues in the Development of Vocational Education," Unemployment in a Prosperous Economy (William G. Bowen and Frederick C. Harbison, eds.), Princeton, 1965; available as Brookings Institution Reprint No. 112.

"Characteristics of 'Other' Families," with John C. Beresford, Demography, Vol. 1, No., 1964.

"Research in the Economics of Higher Education: Progress and Problems," Selma J. Mushkin (ed.) Economics of Higher Education, Washington, D.C.: U.S. Department of Health, Education, and Welfare, 1962; available as the Brookings Institution Reprint No. 63.

"An Economic and Demographic Model of the Household Sector: A Progress Report," (with Guy H. Orcutt), National Bureau of Economic Research, New York, Demographic and Economic Change in Developed Countries, Princeton: Princeton University Press, 1960.

PREPARED STATEMENT OF LAURENCE H. MEYER

Mr. Chairman and Members of the Committee, it is a pleasure for me to appear before you today as President Clinton's nominee to serve on the Board of Governors of the Federal Reserve System.

If confirmed, I pledge to work with the other Members of the Board to carry out the objectives that you, the Congress, have established for monetary policy and the responsibilities you have entrusted to the Federal Reserve with regard to protecting the safety and soundness of the banking system in particular and financial markets in general, ensuring the efficiency and integrity of the payments process, and enforcing fair lending laws and other consumer legislation. These are wide-ranging and important responsibilities and I look forward to an opportunity to serve the Nation in their pursuit.

Background and Qualifications

I must say at the outset that I believe I have been preparing for this opportunity my whole life. I hold a B.A. in economics from Yale University and a Ph.D. in economics from MIT. Since 1969, I have taught at Washington University, where I am currently a Professor of Economics and Research Associate in the University's Center for the Study of American Business. I have also been a principal in an economic consulting firm, Laurence H. Meyer & Associates, which I began and have participated in since 1982 with two of my former students. The firm provides modeling, forecasting, and policy analysis to Government agencies, trade associations, and private firms. Along the way I have had the opportunity to spend a year at the Federal Reserve Bank of New York and another year at the Federal Reserve Bank of St. Louis.

I have published research on a range of topics in macroeconomics, a textbook on macroeconomic modeling, and numerous studies on policy-related topics, for the most part with my partners in my consulting firm, with a special focus on the economic consequences of deficit reduction and tax reform.

The model developed by my firm has been in use at the Council of Economic Advisers, the Office of Management and Budget, and the Department of Treasury in this and the preceding two Administrations, is used by both the nonpartisan Congressional Budget Office and the Board of Governors of the Federal Reserve System, and, more recently, has found a home at the House Budget Committee and the Joint Tax Committee. Our interpretation of the economic outlook and our analysis of policy initiatives is widely appreciated. In two of the last 3 years I have received the Annual Forecast Award, on behalf of my firm, recognizing the most accurate forecaster on the Blue Chip Economic Indicators forecast panel. The first award was for the period 1989–1992 and the second for the period 1991–1994.

Monetary Policy Objectives

I stated earlier my affirmation of the objectives for monetary policy detailed in the Federal Reserve Act. These objectives are "maximum employment, stable prices, and moderate long-term interest rates." Such an affirmation, however, may leave open in your minds important questions about my view of the role of monetary policy and you deserve a more detailed statement from me.

Economists usually identify three objectives as central to excellent macroeconomic performance. These objectives are price stability, full employment, and adequate growth. I want to address the role of monetary policy in relation to each objective and also indicate my perspective on how we are doing at the moment with respect to each.

I have chosen an ordering of the objectives that reflects the degree of control and therefore responsibility that the Federal Reserve has over each. One of the themes I want to develop here is that you should never expect more of policy than it can deliver.

Price stability comes first because it is the singular goal for monetary policy in the long run. Inflation undermines the efficiency of the economy and may also, through its interaction with our tax system, discourage saving and investment. Promoting price stability is the principal contribution monetary policy can make toward achieving high living standards in the long run. Macroeconomic theory tells us that, in the long run, inflation is principally caused by money supply growth which in turn is determined by the Federal Reserve System. When it comes to price stability, therefore, the buck literally stops at the Federal Reserve. To be sure, in the short run, inflation can be affected by a variety of other factors, including the degree of slack in labor and product markets and external supply shocks such as weather-induced surges in food prices or politically-inspired jumps in oil prices. None of this overrides the ultimate responsibility of the Federal Reserve for containing inflation in the long run.

Chairman Greenspan has suggested that price stability is achieved when inflation expectations no longer influence household and business decisions. This statement of the objective does not link it to a specific price index (there being several measures of inflation deserving of consideration), nor does it identify a specific quantitative target (a task compromised by the now well appreciated but still quantitatively uncertain biases in many of our price indexes). And, yet, no one on the Committee, I expect, doubts the seriousness of the Chairman's commitment to price stability. I hope you will come to trust my commitment as equal to the Chairman's.

We have made continuing and impressive progress toward achieving price stability. The inflation rate for the CPI, for example, has been near 2½ percent over each of the past 2 years. Let me also note that, unlike most private forecasters, I have shown great confidence in the Federal Reserve by projecting inflation at 2 percent or lower over 5 years, compared with consensus forecasts closer to 3 percent. It will be my pleasure to serve on the Board, if confirmed, during a period when price stability is at last within reach.

A brief comment about the objective of "moderate long-term interest rates" is in order before moving on to the full employment and growth objectives. In the long run the major influence of the Federal Reserve on nominal interest rates arises from it's effect on inflation and hence on inflation expectations. Therefore, meeting the price stability objective directly ensures that the Federal Reserve will be promoting moderate long-term interest rates. Real interest rates, on the other hand, are influenced, at least in the long run, principally by saving and investment propensities in the private sector and by fiscal policy decisions related to both the tax structure and the deficit. Monetary policy, in contrast, has little influence on real interest rates in the long run.

The second (independent) goal, full employment, is the basis for the commitment in the Federal Reserve Act to "maximum employment." The language in the Act leaves much to be desired from the standpoint of precision. But if we accept that "maximum employment" can be translated as "achieving and maintaining full employment," then "all" we have to do is to define full employment. The conventional wisdom, which I fully endorse, holds that full employment is the maximum level of employment that can be sustained without suffering increasing inflation. We, therefore, refer to the unemployment rate at full employment as NAIRU, the non-accelerating inflation rate of unemployment. Below this threshold, inflation increases progressively and indefinitely. Above this threshold, we achieve continuous disinflation. At NAIRU, and only at NAIRU, inflation is constant.

This view implies that there is no long-run tradeoff between inflation and unemployment. Therefore, there is no conflict in the long run between the objectives of price stability and full employment. The unemployment rate is 5½ percent today. That is at the bottom end of the 5½ percent to 6 percent range for NAIRU that most students of this subject, including myself, feel comfortable with. Nevertheless, NAIRU has to be estimated, not measured, and is subject to variation through structural change in the economy. I constantly monitored and occasionally adjusted our estimation of NAIRU at Laurence H. Meyer & Associates and will continue to be open to new evidence on this subject.

The third goal, adequate economic growth, has certainly received its fair share of attention of late. As you know, the President has focused considerable attention on this goal, and appropriately so, in light of the disappointing rate of growth in GDP on average since the early 1970's and the near stagnation in the real spendable income of the median family over the past 20 years. Before I present my views on the role of monetary policy with respect to growth, let me clarify this goal and distinguish it from that of full employment. By growth, I mean the growth in the economy's productive capacity: This is the rate of growth possible once the economy has achieved full employment. It will also be very close to the actual growth observed over periods long enough to wash out the effect of business cycles. I will refer to this as "trend growth." Trend growth is the result of the growth in the labor force, the growth in the capital stock, and the advance in knowledge.

The Federal Reserve cannot, itself, raise trend growth. Growth is predominately the outcome of private sector decisions related to work effort, education, research and development, saving, and investment. Yet public policy can make a difference. Without meaning to overstate the degree to which Congress can raise the economy's growth potential, your success in balancing the Federal budget, in weeding out public investments with low rates of return while funding amply those with high rates of return, in complementing good intentions in regulatory intervention with the discipline to minimize the costs to the private sector, and in sensibly reforming the tax code to lower marginal tax rates and ensure adequate incentives for investment will be the policy decisions that have the potential to make a difference.

What then is the role of the Federal Reserve with respect to growth? I would term this role "accommodative" and stand with Chairman Greenspan in his comments on this subject in his recent Humphrey-Hawkins testimony. The Federal Reserve should support the full measure of growth that the economy's increase in productive capacity permits. Growth, as I have defined it here, does not cause inflation. It is not a threat. It is the vehicle for higher living standards that we all want to achieve.

It is not very difficult to compute the trend rate of growth in the economy over some historical period. For example, the rate of growth in real GDP from the third quarter of 1990 to the third quarter of 1995 (both associated with identical 5.5 percent unemployment rates) and 2.0 percent. Projections of future growth are typically just extrapolations from recent historical experience, with adjustment, for example, for changes in labor force growth based on Census Bureau population projections. We can hope for—and some may even feel comfortable in projecting—a speed-up in trend growth going forward. My responsibility on the Board, if confirmed, will be to ensure that monetary policy would support any improvement in growth that may lie ahead.

While there is no conflict among the three objectives in the long run, there can be conflicts in the short run and it is in such a situation where tough choices are made and good judgment is required. Consider a set of initial conditions where inflation is above its long-run target level. The only sure way to reduce inflation is to endure a period of unemployment above the full employment level and this higher unemployment would be produced, in turn, by a period of below-trend growth. The Federal Reserve in recent years, however, has developed a strategy that minimizes the conflict between the objectives under these circumstance. I have referred to this strategy as "opportunistic disinflation" and applauded its implementation. The Federal Reserve moved aggressively, under this strategy, to prevent a breakout of inflation as the economy approached full employment in the current expansion. The result has been well-contained inflation and an unemployment rate of 5½ percent today. At this point, this strategy calls for the Federal Reserve to patiently support a continued expansion at full employment and at the trend rate of growth. Recessions, however, are inevitable, despite the efforts of the Federal Reserve to promote continued growth at full employment. When the next recession arrives, whatever the timing, inflation will ratchet down another notch. This strategy gradually and at low cost lowers inflation over time until price stability is achieved.

Independence and Disclosure

I support the independence of the Federal Reserve System. History speaks clearly to the point that central bank independence is a critical ingredient to ensuring a steady commitment to price stability.

Finally, it serves the ends of monetary policy well to communicate Federal Reserve decisions in a clear and timely fashion. I applaud the recent innovation of ending each FOMC meeting with a statement that summarizes the decision taken and that includes at least a brief explanation of any policy change that has been taken.

Regulation

Whereas I have studied and written about monetary policy throughout my entire career, I have invested less time in and, as a result, have been quiet about the regulatory side of the Federal Reserve's responsibilities. I am now involved in a crash course in these areas. These are important responsibilities.

I shall present here only a broad perspective on the fundamental principles that will shape my views with respect to specific issues. I believe strongly in the value of cost-benefit analysis in the development and implementation of Government regulation. Good intentions are a good start, but they are not an excuse for disregard for the private sector costs of regulatory intervention.

But neither is the concern over the cost of compliance an excuse for failing to serve the public good through appropriate regulatory policies. Balance here, as in all such situations, is the rule of reason and the rule I shall strictly apply in these matters if you confirm my nomination.

Conclusion

I want to thank this Committee for the speed with which this hearing has been scheduled. I shall be happy to answer any questions you may have.

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: Meyer, Laurence Harvey

Position to which nominated: Member, Board of Governors, Federal Reserve System

Date of nomination: February 22, 1996

Date of birth: 8/3/44

Place of birth: Bronx, NY

Marital status: Married

Full name of spouse: Florence Krauser Meyer

Names and ages of children: Kenneth Michael Meyer, 25

Stephanie Alix Meyer, 22

Education:

Massachusetts Institute of Technology	1965 - 1969	Ph.D.	1970
Yale University	1961 - 1965	B.A.	1965
The Kew-Forest School	1957-1961	diploma	1961

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Charles Heber Dickerman Memorial Prize, best senior honors essay in economics, Yale University, June 1965

Omicron Delta Epsilon, honorary society in economics, 1965

Phi Beta Kappa, 1965

Woodrow Wilson Fellowship, 1965/6

National Defense Education Act (NDEA) Fellowship, 1966/69

Washington University Council of Students of Arts & Sciences Teaching Award, 1977/8

Washington University Inter-Fraternity Council Excellence in Teaching Award, April 1987

Annual Blue Chip Economic Forecasting Award, 1993, 1995

Fellow, National Association of Business Economists, 1994

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Midwest Economics Association	First Vice President, 1990/91	
American Economic Association	None	1969-Present
Congregation Bnai Amoona		1970 - Present
Chair, Adult Education Committee		1984
Bnai Amoona Men's Club		1975-Present
Yale Club of St. Louis		1970 - Present
Yale Alumni Schools Committee		1971-74
Yale Alumni Representative		1994/5
Friends of the St. Louis Zoo		1977- Present
Friends of the Botanical Garden		1980- Present
Friends of KETC Channel 9		1980-Present
Friends of KMUW		1985-Present
Friends of the St. Louis Art Museum		1980-Present

Friends of Jewish Center for the Aged	1985 - Present
Freinds of the Science Center	1982 - Present
U.S. Holocaust Memorial Council	1994-Present

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

Research Assistant to Professors Albert Ando and Franco Modigliani, 1966 - 1969

Assistant Professor, Washington University, 1969 - 76 (on leave, 1975/6)

Economist, Federal Reserve Bank of New York, 1975/6

Visiting Professor, Pace College, 1975/6

Visiting Assistant Professor, Graduate Center, City College of New York, Fall 1975

Visiting Professor, New York University, Spring 1976

Associate Professor, Washington University, 1976 - 82

Visiting Scholar, Federal Reserve Bank of St. Louis, 1979/80

Visiting Lecturer, Queen Mary College, University of, London, Fall 1978

Chairman, Economics Department, Washington University, 1980/83

Professor, Washington University, 1982 - Present

President, Laurence H. Meyer & Associates, Ltd., 1982 - Present

Research Associate, Center for the Study of American Business, 1984 - Present

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

Consulting relationships through Laurence H. Meyer & Associates

Council of Economic Advisers
The Office of Management and Budget
The U.S. Department of Treasury
The Department of Commerce
Congressional Budget Office
The House Budget Committee
The Joint Economic Committee
The State of Missouri, Division of Budget and Planning
Illinois Department of Employment Security

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

Journal articles, books, and chapters of books

"A Test of the Specification and Channels of Monetary Policy in the FRB-MIT-Penn Model", 1971 Proceedings of the Business and Economics Statistics Section of the American Statistical Association.

"The Response of Interest Rates to Monetary Change: A Simulation Study", 1972 Proceedings of the Business and Economics Statistics Section of the American Statistical Association.

Review of E.S. Phelps, "Inflation Policy and Unemployment Theory", Journal of Finance, June 1973.

"Wealth Effects and the Effectiveness of Monetary and Fiscal Policies, Journal of Money, Credit, and Banking, November 1974.

"Lagged Adjustment in Simple Macro Models", Oxford Economic Papers, November 1974.

"The Balance Sheet Identity, the Government Financing Constraint, and the Crowding-Out Effect", Journal of Monetary Economics, January 1975.

"Optimal Coordination of Aggregate Stabilization Policy and Price Controls: Some Simulation Results" (with S.K. Gupta, F.Q. Raines, and T.J. Tarn), Annals of Economic and Social Measurement, Spring 1975.

"The Effects of Fiscal and Monetary Policy: Completing the Taxonomy" (with W.R. Hart), American Economic Review, September 1975.

"Optimal Coordination of Aggregate Stabilization Policy and Price Controls: A Sensitivity Analysis" Proceedings of the 6th Triennial World Congress of the International Federation of Automatic Control, 1975.

"Neutrality and Tax Discounting", Metroeconomica, December 1975.

"An Empirical Investigation of the Extent of Tax Discounting" (with J. Yawitz), Journal of Money, Credit, and Banking, May 1976.

"Alternative Definitions of the Money Stock and the Demand for Money", Federal Reserve Bank of New York Monthly Review, October 1976.

"Interest-Induced Wealth Effects and the Behavior of Real and Nominal Interest Rates: A Comment" (with J. Yawitz), Journal of Finance, March 1977.

"The Demand for Money and Bonds in Continuous Time Models: A Comment", Journal of Economic Theory, June 1977.

"Empirical Evidence on the Effects of Stabilization Policy" (with R. Rasche), in Stabilization Policy: Lessons from the 1970's and Implications for the 1980's, 1980.

Macroeconomics: A Model Building Approach, South-Western Publishing Company, 1980.

"On the Cost and Benefits of Anti-Inflation Policies" (with R. Rasche), Federal Reserve Bank of St. Louis Review, February 1980.

"Financing Constraints and the Short-Run Response to Fiscal Policy", Federal Reserve Bank of St. Louis Review, June-July, 1980.

The Supply Side Effects of Economic Policy, editor, Kluwer-Nijhoff Publishing Company, 1981.

"A Comparison of the St. Louis Model and Two Variations: Predictive Performance and Policy Implications (with C. Varvares)", Federal Reserve Bank of St. Louis Review, December 1981.

"Monetary Policy and Rational Expectations: A Comparison of Least Squares and Bayesian Learning"(with C. Webster), in Carnegie-Rochester Conference on Public Policy, Fall 1982.

Improving Money Stock Control: Problems, Solutions, and Consequences, editor, Kluwer-Nijhoff Publishing Company, 1983.

"The Cost of Imprecise Monetary Control" (with C. Webster), in Improving Money Stock Control: Problems, Solutions, and Consequences, Kluwer-Nijhoff Publishing Company, 1983.

The Economic Consequences of Government Deficits, editor, Kluwer-Nijhoff Publishing Company, 1984.

"Financial Innovation and Monetary Targeting: Discussion", in Financial Innovations: Their Impact on Monetary Policy and Financial Markets, Kluwer-Nijhoff Publishing Company, 1984.

"Balancing the Budget in 1991: An Economic Analysis of the Gramm-Rudman-Hollings Proposal" (with J. Prakken and C. Varvares), appendix to Toward an Economy Without Deficits. A 1985 Yearend Report on the U.S. Economy, Joint Economic Committee of the U.S. Congress, January 1986.

"The Political Economy and Macroeconomic Effects of Deficit Reduction in the U.S.", in Policy Forum on the February 1986 Federal Budget, John Deutsch Institute for the Study of Economic Policy, Queens University, Kingston, Ontario, April 1986.

"The Fisher Equation Controversy: A Reconciliation of Contradictory Results" (with A. Sahu and R. Jha), in Southern Economics Journal, July 1990.

"Two Revolutions in Economic Policy: Growth-Oriented Macro Policy in the Kennedy and Reagan Administrations" (with J. Prakken and C. Varvares), in The Economic Legacy of the Reagan Years: Euphoria or Chaos?, Anandi P. Sahu and R.L. Tracy (ed.), New York: Praeger, 1991.

"Tax Reform and Potential Output: A Retrospective Analysis of the Tax Reform Act of 1986" (with J. Prakken and C. Varvares), in Carnegie-Rochester Conference on Public Policy, Volume 35, Autumn 1992.

"Defense Spending and Economic Growth: Spillovers vs. Crowding Out" (with F.Q. Raines) in Defense Spending and Economic Growth, J. Payne and A Sahu, (ed.), 1993

"Policy Watch: Defining an Effective Investment Tax Credit" (with J. Prakken and C. Varvares), in Journal of Economic Perspectives, Spring 1993.

Comment on Eric Leeper and Chris Sims, "A Modern Macroeconomic Model Usable for Policy Analysis," NBER Macro Annuals 1994, National Bureau of Economic Research, 1994

"Inflation Non-Neutralities and the Response of Interest Rates to Inflation" (with A. Sahu), Eastern Economics Journal, Winter 1994

Monographs, LHM&A Special Analyses and Testimony:

"Deficit Reduction and the Mix of Monetary and Fiscal Policy", testimony presented to the Finance Committee of the U.S. Senate, December 14, 1983.

The Washington University Macroeconometric Model of the U.S. Economy (with J. Prakken and C. Varvares), 1984, 1986, 1989, 1994, 1995.

"Flat Taxes and Capital Formation," (with J. Prakken and C. Varvares), Center for the Study of American Business, October 1984.

"Can We Grow Out of the Deficits?" (with Joel L. Prakken and Chris P. Varvares), LHM&A Special Analysis, August 22, 1984

"The Treasury Department's November 1984 Tax Reform Proposal: Implications for Capital Formation," (with J. Prakken and C. Varvares), study prepared for the Council of Economic Advisors, December 1984.

"The President's Tax Reform Proposal: Implications for Capital Formation," (with J. Prakken and C. Varvares), Center for the Study of American Business, June 1985.

"Tax Reform, Deficit Reduction, and Capital Formation", statement submitted to the Finance Committee of the U.S. Senate, February 15, 1986.

"The Senate Finance Committee Staff Option for Tax Reform: A Macroeconomic Analysis," (with J. Prakken and C. Varvares), Center for the Study of American Business, March 1986.

"The Senate Finance Committee Proposal for Tax Reform: A Macroeconomic Analysis," (with J. Prakken and C. Varvares), Center for the Study of American Business, May 1986.

"Balancing the Budget: A Reconsideration of Gramm-Rudman," (with J. Prakken and C. Varvares), LHM&A Special Analysis, February 1987

"Macroeconomic Consequences of the New Tax Law in the Short and Long Runs," LHM&A Special Analysis, September 1987

"The Federal Budget: Looking into the 1990's," testimony before the National Republican Congressional Committee, February 29, 1988.

"The Implications of Iraq's Attack on Kuwait Analysis," (with J. Prakken and C. Varvares), LHM&A Special Analysis, August 2, 1990
"

"Implications of War with Iraq for the U.S. Economy," (with J. Prakken and C. Varvares), LHM&A Special Analysis, November 14, 1990

"Balancing the Budget: An Analysis of the Effects of Deficit Reduction Economy," (with J. Prakken and C. Varvares), prepared for Chase Manhattan Bank, August 15, 1991

"What Policies Work to Promote Long-term Economic Growth?," prepared for the U.S. Chamber of Commerce, January 16, 1992

"The Macroeconomics of Credit Card Interest Rate Caps," (with J. Prakken and C. Varvares), prepared for the Credit Card Coalition, March 9, 1992

"Balancing the Budget: An Analysis of the Economic Effects of Deficit Reduction Caps," (with Joel Prakken and Chris Varvares), prepared for Chase Manhattan Bank, October 1992

"The Economic Effects of the Clinton Program," LHM&A Special Analysis, (with J. Prakken and C. Varvares), November 7, 1992

"Macroeconomic Aspects of the Republican 'Contract with America'," LHM&A Special Analysis (with J. Prakken and C. Varvares), February 28, 1995

"Economic Forecasts Deficit-Reduction and Productivity Growth," testimony presented to the Committee on the Budget, U.S. House of Representatives. March 7, 1995

"The Benchmanrk Revisions of the NIPA and Implications for the Forecast," (with J. Prakken and Chris Varvares), LHM&A Special Analysis, January 31, 1996

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Consulted for Clinton Campaign Committee, 1992: studied the effect of an incremental tax credit and other options to stimulate the economy.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

None

Qualifications: State fully your qualifications to serve in the position to which you have been named.

I believe my education, my research, my experience within the Federal Reserve System, my talents in forecasting and policy analysis, and my experience interpreting the economic outlook and analyzing monetary and fiscal polices has prepared me well for the challenges associated with being a member of the Board of Governors.

I studied economics as an undergraduate at Yale University, graduating in *1965 manga cum laude* and with distinction in economics. I was also admitted to Phi Beta Kappa. After Yale, I went to graduate school at MIT where I concentrated in macroeconomics and monetary theory and was taught by an outstanding faculty including Nobel Laureates Franco Modigliani, Robert Solow and Paul Samuelson. An important foundation for my knowledge about macroeconomic models is the experience I had as a Research Assistant to Professors Franco Modigliani and Albert Ando in connection with their work on the MPS Model. This model, when completed, found a home at the Board of Governors where research on it continues and where it remains an important input into the forecasting and policy analysis by the staff at the Board. I received my Ph.D. from MIT in 1970.

I have been on the faculty at Washington University since leaving MIT. My research has focused on understanding the channels of monetary policy; modeling the role of financial markets in the determination of output, prices and interest rates; on the response of nominal interest rates to inflation; on policies to raise the growth rate of output over the long run; and on the way in which credibility about monetary policy can lower the

cost of disinflation. Additional research, most of it joint with my two partners, has been circulated as Special Analyses by my consulting firm, Laurence H. Meyer & Associates. This work has focused principally on estimating the quantitative impacts of deficit reduction and tax reform on the economy's intermediate term rate of economic growth.

My 27 years of teaching at Washington University has helped me learn how to communicate effectively with both economists and non-economists.

My experience at Laurence H. Meyer & Associates has helped me to develop my skills as an economic forecaster. Our record for forecast accuracy is well known and widely appreciated. I was recognized as the top forecaster on the Business Week forecast panel for LHM&A's 1986 forecast. In both 1993 and 1995, I won the Annual Blue Chip Economic Forecast Award -- in 1993 for LHM&A's forecasts over the period 1989 - 1992 and in 1995 for LHM&A's forecasts over the period from 1991 - 1994. At the Board, the timing and aggressiveness of monetary policy decisions clearly are influenced by perceptions about the cyclical strength of the economy and the underlying trend in inflation. I have wrestled with these issues for my entire career, particularly intensively in my work for Laurence H. Meyer & Associates. Through my work with LHM&A, I have been a consultant to the Council of Economic Advisers, the Office of Management and Budget, the Department of Treasury, the Congressional Budget Office, the House Budget Committee, the Joint Tax Committee, and the Board of Governors. In this capacity, I have had a chance to provide both forecasts, analysis of policies, and policy recommendations.

Future employment relationships:

1. **Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.** Yes. I will divest my financial interest in Laurence H. Meyer & Associates and take a leave of absence from Washington University.

2. **As far as can be seen, state whether you have plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.** I have no plans or commitments.

3. **Has anybody made you a commitment to a job after you leave government?** No.

4. **Do you expect to serve the full term for which you have been appointed?** Yes.

Potential conflicts of interest

1. **Describe any financial arrangements or deferred compensation agreements, or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.** I have a Washington University retirement account with TIAA/CREF. The University will, I expect, continue to make payments into this account (subject to some matching by me) while I am on leave and dividends and interest will continue to be re-invested. I will roll over my profit sharing balance from Laurence H. Meyer & Associates into an IRA managed by Buckingham Asset Management, Clayton Missouri. The IRA will be invested in a variety of mutual funds.

2. **List any investments, obligations liabilities or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.** Most of my other financial assets are and will continue to be managed in the same way as my rollover IRA by Buckingham Asset Management. I will sell any mutual funds that invest only in government bonds.

3. **Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.** I have consulted for many government agencies over this period, but none of these consulting relationships would, in my view, pose a conflict of interest problem. Nevertheless, to insure the most complete possible disclosure for the committee's benefit, I report here the various government agencies for which Laurence H. Meyer & Associates now or over the past 10 years has consulted.

The President's Council of Economic Advisers
The U.S. Department of Treasury
The Office of Management and Budget
The U.S. Commerce Department (International Trade Administration)
The U.S. Department of Labor
The Congressional Budget Office
The Joint Committee on Taxation
The House Budget Committee

4. **List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.**

None

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items. I will do as instructed by the ethics officer at the board of Governors and as required by the committee.

Civil, criminal, and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation..

On November 1968, I was in an automobile accident in which my wife received a cut on her forehead. Subsequently, my wife sued me to collect compensation for the injury from the insurance company. The suit was settled out of court. The details are available in docket # 120475 for the Superior Court, New Haven County.

2. Give the full details of any proceedings, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation. None

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: Greenspan (LAST) Alan (FIRST) (nmn) (OTHER)

Position to which nominated: Chairman of the Board of Governors of the Federal Reserve System

Date of nomination:

Date of birth: 06 (DAY) 03 (MONTH) 26 (YEAR)

Place of birth: Bronx, NY

Marital status: single

Full name of spouse:

Name and ages of children: none

Education:

Institution	Dates attended	Degrees received	Dates of degrees
George Washington HS	1940-43	diploma	
New York, NY			
New York University	1945-48	B.S.	1948
New York University	1948-50	M.S.	1950
New York University	1977	Ph.D.	1977

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

University of Notre Dame, Doctor of Laws (honorary), 1995

Wake Forest University, Doctor of Laws (honorary), 1989

Colgate University, Doctor of Humane Letters (honorary), 1987

Hofstra University, Doctor of Humane Letters (honorary), 1984

Pace University, Doctor of Commercial Science (honorary), 1981

Fellow of the American Statistical Association, 1989

Thomas Jefferson Award for the Greatest Public Service Performed by an elected or appointed official, presented by the American Institute for Public Service, 1976

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
see page S-1 attached		

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

Research Associate; National Industrial Conference Board,
New York, NY, 1948-1953

Economic consultant, Townsend-Greenspan & Co., Inc., New York, NY, 1953-1974, 1977-1987; Chairman and President 1954-1974, 1977-1987, Chairman June 1987-July 31, 1987

Chairman, Council of Economic Advisers, Washington, DC, 1974-1977

Chairman, Board of Governors of the Federal Reserve System, Washington, DC, 1987-present

For additional, see page S-2 attached

Government experience:

List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

Chairman, National Commission on Social Security Reform, 1981-1983

Member, President Reagan's Economic Policy Advisory Board, 1981-1987

Member, President's Foreign Intelligence Advisory Board, 1983-1985

For additional, see page S-3 attached.

Published writings:

List the titles, publishers and dates of books, articles, reports or other published materials you have written.

For list of representative articles written since 1980, see page S-3 attached.

Political affiliations and activities:

List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

none

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

none

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

See page S-4 attached.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

   no

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

   no

3. Has anybody made you a commitment to a job after you leave government?

   no

4. Do you expect to serve the full term for which you have been appointed?

   yes

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

Deferred compensation agreements with the following corporate boards:

General Foods Corp., Automatic Data Processing, Inc.

(Final payment from General Foods received 2/27/96.)

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

none

3. Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

See attached copy of letter in response to query in June 1987 by then Chairman Proxmire.

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

See attached copy of letter in response to query in June 1987 by then Chairman Proxmire.

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

I will recuse myself from any particular matter that would directly affect Automatic Data Processing, Inc., the company with which I will have a continuing relationship after February 27, 1996.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

none

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

none

MEMBERSHIPS:

Organization	Office held (if any)	Dates
Gerald R. Ford Foundation	Board of Trustees	1981-1987
The Economic Club of NY	Vice Chairman, Board of Trustees	1984-1987
Council of Foreign Relations	Board of Directors Member	1982-1987 1987-present
Committee For a Responsible Federal Budget	Director	1981-1987
Institute For International Economics	Board of Directors	1981-1987
Hoover Institution	Board of Overseers	1973-1974 1977-1987
The Ronald Reagan Presidential Foundation	Board of Governors	1986-1987
The Trilateral Commission	Member, Executive Committee	1982-1987
Century Country Club Purchase, NY	Member	1979-present
Hillcrest Country Club Los Angeles, CA	Member	1975-present
City Midday Club New York, NY	Member	1983-1987
Harmonie Club	Member Nonresident Member	1971-1987 1987-present
The University Club New York, NY	Member	1979-1989
Conference of Business Economists	Member Past Chairman	1963-1987 1974
National Association of Business Economists	Member, Fellow Past President	Early 60s-present 1969-1970
National Economists Club Washington, DC	Member Past Director	1969-present
Brookings Panel on Economic Activity Washington, DC	Senior Adviser	1970-1974 1977-1987
Chevy Chase Club Chevy Chase, MD	Resident guest	1991-present

EMPLOYMENT RECORD:

Director	Trane World Financial Co., Los Angeles, 1962-1974
Director	Dreyfus Fund, New York, 1970-1974
Director	Dreyfus Special Income Fund, New York, 1971-1974
Director	General Cable Corp., New York, 1973-1974, 1977-1978
Director	Sun Chemical Corp., New York, 1973-1974
Director	Dreyfus Liquid Assets, Inc., New York, 1973-1974
Director	Standard & Poor's InterCapital Income Securities, Inc., 1973-1974
Director	Bowery Savings Bank, New York, 1974
Director	General Foods Corp., White Plains, 1977-1985
Director	J.P. Morgan & Co., Inc., New York, 1977-1987
Director	Morgan Guaranty Trust Company of New York, New York 1977-1987
Director	Mobil Corporation, New York, 1977-1987
Director	Aluminum Company of America, Pittsburgh, 1978-1987
Director	Automatic Data Processing, Inc., Roseland, NJ, 1980-1987
Director	Capital Cities/ABC, Inc., NY -- (ABC) 1984-1986, (CC/ABC) 1986-1987
Director	The Pittston Company, Greenwich, CT, 1985-1987
Director	The Rand Corporation, Los Angeles, 1986-1987
Member	Board of Economists -- Time Magazine, New York, 1971-1974, 1977-1987

GOVERNMENT EXPERIENCE:

1970-1971 Member, Commission of Financial Structure and Regulation

1969-1970 Member, Commission on an All-Volunteer Armed Force

1969 Member, Task Force on Economic Growth

1977-1987 Consultant, Congressional Budget Office

PUBLISHED WRITINGS:

"The Great Malaise," Challenge (March/April 1980) pp. 37-40.

"Economic Policy," in Peter Duignan and Alvin Rabushka, eds., The United States in the 1980s (Board of Trustees of the Leland Stanford Junior University, 1980).

"Weekly GNP," Roundtable of GNP Users, Studies in Income and Wealth, No. 47 (University of Chicago Press, 1982).

"Competition Means Better Service," At Home With Consumer [The Direct Selling Education Foundation, volume 5, number 3 (September 1984)].

"Risk, Safety and Bank Deregulation," The Sears Sounding Board (Sears Financial Network, 1985).

The Wall Street Journal (New York):

"Can the U.S. Return to a Gold Standard?", September 1, 1981.

"The Collapsing World of OPEC," March 11, 1983.

"Onward The Revolution in Financial Services," September 16, 1983.

"Payment Setup Can't Ensure Medicare's Fit," September 4, 1984.

"Takeovers Rooted in kFear," September 27, 1985.

"Coordination Could Be Washed Out," July 10, 1986.

The Washington Post, "Alan Greenspan:," December 4, 1983.

QUALIFICATIONS:

I have been an economist for almost 45 years, first as an analyst, and in recent years as a consultant. My work has covered both industrial and financial sectors of the United States and, to an increasing extent, the rest of the world. I have considerable knowledge of American financial structure (I served on the President's Commission on Financial Structure and Regulation, 1971) and monetary theory. I have served on the boards of directors of a savings and loan holding company (Trans-World Financial, 1962-1974) and a bank holding company (J.P. Morgan, 1977 to 1987). My service as Chairman of the Council of Economic Advisers (1974-1977) offered opportunities to broaden my experience beyond the private sector. Finally, I have served as Chairman of the Board of Governors of the Federal Reserve System since August 1987.

ALAN GREENSPAN
120 WALL STREET
NEW YORK, N.Y. 10005

June 30, 1987

The Honorable William Proxmire
Chairman
U.S. Senate
Committee on Banking, Housing,
and Urban Affairs
Washington, D.C.

Dear Mr. Chairman:

The following is in response to your letter of June 11th requesting information about certain client relationships.

For purposes of accounting, Townsend-Greenspan & Co. divides its various services into:

(1) general consulting, which reflects our forecasts and analyses of the economic outlook.

(2) Specifically designed client presentations on analytical subjects, such as facilities planning techniques, the long-term world demand for oil, etc.

(3) What we call "advocacy projects," which reflect any analysis or presentation that is directed, not at forecasting but, to the development of ideas, which lead to a particular point of view on company, industry, or public policy. We make it clear to potential clients for such services that these are our positions and they may or may not choose to publicize the results of our work. Some have chosen not to. These presentations generally reflect my personal views on specific policy questions, almost always as an extension of some analytical research. Much of the economic analysis in this segment of our business has been in support of my personal views on the necessity to protect intellectual property rights, and to further financial deregulation.

Committee on Banking, Housing,
and Urban Affairs
Page 2
June 30, 1987

to assist their client, Lincoln Savings and Loan Association, in an evaluation of the desirability of broadened savings and loan direct investment powers. This resulted in a published study submitted to the Federal Home Loan Bank Board and was subsequently the basis of invited testimony before the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Government Operations (February 27, 1985).

Our total billing (including expenses) to Paul, Weiss, Rifkind, Wharton & Garrison, was:

1984	$
1985	
1986	
1987	
Total	$

This project is now complete.

Sears Roebuck and Company is a regular general consulting client for whom we also consult on various aspects of financial structure and regulation. We have been asked to analyze and criticize a number of their proposed initiatives in the financial services area. I have also made a number of presentations on their behalf before various private associations and groups outlining my views on financial deregulation. Our total annual retainer from Sears has been $. It covers my personal time devoted to presentations and analyses, as well as the time of our staff.

If there is any additional information I can present, please let me know and I will endeavor to make it available.

Sincerely,

Alan Greenspan

AG:an

PREPARED STATEMENT OF RALPH NADER

ON THE NOMINATION OF ALAN GREENSPAN AS CHAIRMAN OF THE FEDERAL RESERVE BOARD

MARCH 26, 1996

Mr. Chairman, thank you for this opportunity to comment on the renomination of Alan Greenspan as Chairman of the Federal Reserve Board and the present state of the Federal Reserve System under his tenure.

There is a need for change at the Federal Reserve. There is an overriding need to make the agency less wasteful, more open, more effective, and more responsive to a broader segment of the American population.

The nomination of Alan Greenspan for a third term as Chairman of the Federal Reserve Board comes against a backdrop of growing unease about job insecurity and corporate downsizing in a slow-growth economy characterized by wage stagnation and decline and growing disparities of wealth.

Pollsters, the media, and political candidates are becoming increasingly aware of the anger and disappointment of both blue collar and white collar workers who have lost jobs or been forced to uproot their families in search of new jobs with less pay and less satisfaction. In recent weeks, the New York Times used hundreds of column inches to chronicle the new era of economic insecurity in an unprecedented seven-part series.

The President—and I assume shortly the Senate—appear willing to answer these concerns with a "business as usual" message—or, more to the point, a "Federal Reserve as usual" response. The reappointment of Alan Greenspan—who has controlled a major share of the Government's economic policymaking machinery since 1987 can be interpreted only as a desire to maintain the status quo.

With two vacancies on the Board and with the Chairmanship open, the President had a golden opportunity to reshape the Federal Reserve and, at minimum, open a debate within the Board about monetary policy options. It was also an opportunity to let sunlight in and turn the agency away from its obsession with secrecy and its apparent unease with the right of the people to know what their Government is doing. But, the President's decision to keep the monetary policy reins in the hands of Alan Greenspan effectively closes the door on the possibility for change at the Federal Reserve. And if the published predictions are correct, the Republican majority in the Senate will be happy to accept the President's decision that all is well at the Federal Reserve.

While disagreeing strongly, I have no illusions about the ultimate outcome of this nomination process. For 8 long years, the Congress has seemed willing to accept most, if not all, of Alan Greenspan's bland assurances when he visits Capitol Hill twice each year to report on monetary policy. These reports are invariably self-congratulatory messages from the Federal Reserve—reports from the battlefront against real or imagined inflation. If Congress sees problems in the economy, the Federal Reserve is quick to assign blame elsewhere.

In his testimony last month, Alan Greenspan was forced to concede that there was, indeed, growing anxiety about job security among the Nation's middle class. The blame, he contended, was essentially "technological change"—an analysis that he hoped would send a message that neither the Fed nor the banks nor any large companies are part of the problem.

While accepting no responsibility, he did nonetheless dust off the subject with a note of what he must have regarded as compassion for the workers caught in corporate downsizing in a slow growth economy. "The phenomenon of [corporate] restructuring," he told the Congress, "can be *especially unfortunate* for those workers directly caught up in the process." A message to be read aloud when the corporate personnel office announces a new layoff.

Some of these workers may feel it was "especially unfortunate" that Alan Greenspan's Federal Reserve decided to increase interest rates sharply in rapid fire actions between mid-1994 and early 1995.

As John Berry, the Washington Post's reporter on the Federal Reserve beat noted, many economists believe this interest rate shock accounts for the exceedingly slow economic growth last year. The inflation-adjusted gross domestic product rose just 1.4 percent from the end of 1994 to the end of last year—compared with 3.5 percent in 1994. The economy is continuing to experience slow growth, not to mention how the fruits of this growth are distributed. Asked about the reasons for the big interest rate increases in the 1994–1995 period, Greenspan resorted to the Federal Reserve's age-old excuse—"inflationary expectations."

In an attempt to refute charges that the Fed's vision of inflation had been illusory, Greenspan, using the analogy of a river, told the House Banking Committee

in February that he had seen a "flood crest" of inflation coming down the river and, as a result, felt the need to pile up interest rate sandbags.

The analogy was less than convincing to Representative Maurice Hinchey of New York who replied that, "many of us looked at that same river and saw a mere trickle of a stream, not threatening anyone at all, and the placing of sandbags up around such a benign trickle of a stream seemed in, itself, extreme . . ."

But, the Federal Reserve's repeated visions of inflation are nothing new. It is boiler plate to excuse monetary policy mistakes. The Federal Reserve's preoccupation with fighting "inflation ghosts" ignores the broader and specific mandate added to the Federal Reserve Act on November 16, 1977 to "maintain the long run growth of monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The ability of Alan Greenspan and his predecessors to ignore the Federal Reserve's broader responsibilities can be credited to the mystique that surrounds the agency and the general failure of the media and the Congress to explain the role of the Federal Reserve in anything but the most complex and confusing terms. Few Americans are focused on the renomination of Alan Greenspan and even fewer understand the large power that the Federal Reserve exercises over their lives. The Fed makes sure that such a condition remains undisturbed by any of its actions.

Whether workers have jobs or families can afford shelter or young people can go to college depends, in a substantial way, on the decisions that are made on interest rates and monetary policy behind the closed doors of the Federal Reserve Board. The Federal Reserve, if it so chooses, can use monetary policy to literally negate—veto—fiscal policies that may be undertaken by the Congress.

This is also a Board that makes key regulatory decisions affecting the safety and soundness of taxpayer-backed deposit insurance funds. And a Board which has a critical say about what safeguards are enforced for consumers in the financial marketplace. For low- and moderate-income and minority citizens, the Federal Reserve's approach to the Community Reinvestment Act (CRA) and the Equal Credit Opportunity Act can be the difference between opportunity and despair.

The Chairmanship of the Federal Reserve has always defined Federal Reserve policy, overshadowing the role of the other six members of the Board and the 12 Federal Reserve Bank Presidents. And the boards under most Federal Reserve Chairmen have been relatively low-key with few public dissents.

This has been especially true under Chairman Greenspan. More and more, the votes of the Board and the Federal Open Market Committee (FOMC) have taken on a monolithic appearance. On the public record, at least, it is lockstep with the Chairman in a manner that would have made the old Soviet Politburo proud. Many believe that there are differences among the members, but that these are papered over and kept secret while only the unanimous agreement appears in the votes released to the media and Congress.

Claims of Independence

The Federal Reserve's statutory powers are magnified by the lack of effective ongoing Congressional oversight, a heavy curtain of secrecy that builds the agency's mystique and hides its mistakes, and the lack of accountability that other agencies face in the budget and appropriations process.

But the biggest piece of armor in the possession of the Federal Reserve is its claim of absolute "independence." Challenged in any forum—Congressional, Presidential, or media—the Federal Reserve will invariably retreat behind its self-constructed wall of "independence." The word "independence" does not appear in the Federal Reserve Act. But, the Federal Reserve has assumed it and has given the word a new and powerful definition.

Proposals to change the Federal Reserve Act, Board operating procedures and other policies are always greeted with sounds of alarm from the Federal Reserve and its apologists proclaiming a threat to the "independence" of the agency. Any call for accountability and openness is interpreted as a threat to its "independence" and as an attempt to exert "political influence" over its decisions.

Never is the Federal Reserve's version of "independence" defined. Is it independence from the Government, the Executive Branch and the Legislative Branch—and the American people? Tracking the expanding claims of "independence" leads one to wonder if the Federal Reserve regards itself as almost a "separate government"—autonomously setting its own rules without regard to the checks and balances that control our democratic system.

While the Federal Reserve may regard itself as "independent" from the rest of the Government, it seems much less "independent" from the banking industry and big business. It appears quite solicitous of these areas of the economy. The majority of

the members of the boards of directors of the 12 Federal Reserve Banks and their 25 branches are drawn from banking and business.

It was instructive to observe the reactions of Wall Street and the banking industry when rumors rose earlier this year to suggest that President Clinton might choose his own Federal Reserve Chairman. The word immediately circulated that Wall Street would throw a full-scale tantrum unless Greenspan was reappointed. Never mind that the President and the American people might want someone else—Wall Street and the banks would riot. Clearly, the banks and Wall Street provide a ready and powerful lobbying arm for the Federal Reserve and its Chairman—and this might just suggest that "independence" has a limit.

As this Committee is aware, five members of the Federal Open Market Committee—the center of monetary policymaking—are Presidents of Federal Reserve Banks elected [with approval of the Fed Board] by boards of directors dawn in large part from banking and business corporations. (The President of the New York Federal Reserve Bank is a permanent member of FOMC and four other presidents serve as voting members of FOMC on a rotating basis.) Such links certainly do not suggest "independence" from the banking and business corporations that hold seats on the district banks' boards of directors.

Let me note here, Mr. Chairman, that Senator Paul Sarbanes, the Ranking Democrat on this Committee, has introduced legislation that would remove this conflict of interest and limit the Open Market Committee solely to the seven members of the Federal Reserve Board who are appointed by the President of the United States.

In the final analysis, the Federal Reserve's "independence" is a shield against accountability. Challenged on any front, the Federal Reserve retreats behind this shield. Bad policy, outrageous mistakes, mismanagement can and are rendered immune from exposure by the Federal Reserve's invocation of "independence"—a device that exceeds even the most outlandish uses of "Executive Privilege" by Presidents down through history.

Secrecy

Going hand in glove with "independence" as a source of Federal Reserve power is the agency's ability to maintain a CIA-like secrecy over virtually all of its operations. The meetings of the Federal Open Market Committee—the body that establishes monetary policy—are shrouded in secrecy despite the fact that its decisions are critical to the well being of all Americans. The General Accounting Office (GAO)—Congresses' watchdog over Federal agencies—is barred from examining anything at the Federal Reserve that remotely involves monetary policy. And as one would expect, the Federal Reserve stretches the definition of "monetary policy" as far as possible to keep the GAO locked out and the Federal Reserve's secrets safe from public scrutiny.

The real meat of monetary policy decisions—the debates of the Federal Open Market Committee (FOMC)—are withheld for 5 years. And even then the transcripts in the words of the Federal Reserve are "lightly edited." The full unedited transcripts are locked away for 30 years. What this means is that the thinking behind some of the key decisions during Alan Greenspan's chairmanship will not be available to this Committee when it considers the new nomination. And these decisions include the controversial move to ratchet interest rates up in 1994 and early 1995 at a time when inflation was relatively low.

I do not believe that this Committee would accept this same secrecy from other agencies and departments under its jurisdictioı.. Would this Committee tolerate "hidden agendas" and only vague sketches of policy decisions from the Department of Housing and Urban Development or the Securities and Exchange Commission? I doubt it seriously and it should not do so with the Federal Reserve.

With most of the "final votes" behind the closed doors of the FOMC recorded as unanimous, it is critically important that the background, the debate, and the rationale contained in the FOMC transcripts be made available immediately after the meetings. Whatever happened to the concept that people in a democracy should know how and why their Government is making decisions?

Representative Henry B. Gonzalez, both as Chairman and Ranking Democratic Member of the House Banking Committee, has made a valiant effort to break the Federal Reserve's secrecy. It was his efforts that uncovered the fact that full verbatim transcripts did exist.

Representative Gonzalez's investigations uncovered that the Fed had long operated a taping system at the secret FOMC meetings—apparently without the knowledge of some of the participants. Even with tapings admitted, the Federal Reserve contended that many of the tapes had been taped over and that there were no complete transcripts in existence. Ultimately, the hide-and-seek game ended with a concession by Chairman Greenspan to Representative Gonzalez that, indeed, the tapes

existed and that 17 years of full transcripts were at the Federal Reserve. But, they still remain a secret from the public for at least 5 years after the meetings of the Open Market Committee. This is an absurdity which serves only to protect the Federal Reserve. There can be no public purpose in hiding the facts from the public for 5 long years.

Why does the Federal Reserve maintain such tight secrecy even years after the fact? And even after many of the participants have left the agency?

A quote in the January/February 1995 issue of the Columbia Journalism Review from Ted Balbach, a former research director for the St. Louis Federal Reserve Bank, may provide the real answer: "Remember, secrecy is power."

Where's the Press? Where are the William Grieders?

The head of most Federal agencies that engaged in such an all encompassing game of governmental secrecy would be virtually hounded out of office by the Washington press corps. But, not Alan Greenspan. He lives in a charmed world where reporters don't demand press conferences and rarely complain about vague and confusing statements about policy issues. The very aura around the Federal Reserve is, itself, a controlling process.

As James Risen, a reporter for the Los Angeles Times, noted, "Greenspan takes great pride in his ability to reveal as little as possible."

This practice often delivers to the American public conflicting, if not totally inaccurate, information, about what a major governmental agency is doing. The latest example of this was last June when the confusing double-talk of Chairman Greenspan in a speech in New York City resulted in directly opposite stories in two of the major U.S. daily newspapers—The Washington Post and The New York Times. The Post headline read: "Greenspan Hints Fed May Cut Rates." The New York Times headline read: "Doubts Voiced by Greenspan on a Rate Cut."

To cover his tracks with the press, Greenspan often calls in selected reporters for secret off the record sessions to give the Federal Reserve's special slant on the world and to answer critics of the agency.

Paul Starobin, a reporter for the National Journal writing for the Columbia Journalism Review last year, described the Greenspan media strategy as "soft spin, no fingerprints." In an article entitled, "The Lure of FEDTHINK," Starobin wrote: "Under the hush-hush ground rules set by the Fed Chairman, the journalists are not even allowed to report that they have had a talk with a senior Fed official. It's as if the whole thing never happened."

Mr. Chairman, in passing on this nomination, I hope the Committee will consider carefully where all of this massive game of secrecy, double-talk, and efforts to obscure what a Government agency does fits in a democratic society. Again, I do not think the Members of this Committee, Republicans and Democrats, would accept such extreme secrecy and such tactics of obfuscation from any other agency that appears before the Committee.

No Money Worries at the Fed

All of the claims of "independence" and all the convoluted tactics to ensure secrecy would mean less if the Federal Reserve did not have its own pot of money which allows it to bypass formal budget and appropriations processes.

Virtually all of the Federal Reserve's income comes directly from the U.S. Treasury in the form of interest payments on Government securities it buys and sells in carrying out monetary policy through the Federal Open Market Committee.

That portfolio of Government securities now totals nearly $400 billion at the Federal Reserve and the income of the Fed is in excess of $20 billion annually. It is free to spend whatever part of that sum it desires, no questions asked. The remainder is sent back to the Treasury each year.

The Federal Reserve is currently spending about $2 billion annually—and the figure is rising year to year. There are no limits on what the agency can spend out of the Treasury's $20 billion in interest payments and the various fees collected for services. No formal budget is submitted and there are no tough questions to answer for appropriations committees on Capitol Hill. But every dime the Federal Reserve spends is money that doesn't go back to the Treasury.

Under the secrecy strictures and the lack of full Congressional oversight, it is difficult to know how much unchecked waste there may be in the System. The Federal Reserve System employs 25,000 people nationwide. This includes 730 economists on average an additional $100,000 on contracts for outside economists and related researchers.

When the Federal Reserve System was established in 1913, the 12 Federal Reserve Banks were scattered across the Nation, many as political plums. Before the age of jet airplanes and the advent of instant communications and computer net-

works, the scattered district banks and branches had a modicum of rationale. Today, the bank buildings in many cities stand on expensive mid-city property, maintain large staffs, and perform fewer and fewer essential functions. Former House Banking Chairman Henry Ruess proposed doing away with many of the banks and branches and selling the property.

While some functions may be eliminated in an information age, the Federal Reserve's publications empire goes on unabated. Earlier this year, the Kansas City Business Journal conducted a survey of Federal Reserve publications and described the System as a "virtual publishing machine." The Kansas City Federal Reserve Bank, alone, spent $295,000 on publications, the Journal said. The Journal quoted Dan Schilling, an Associate Professor of Economics at the University of Missouri, as saying that the, "Federal Reserve in essence talks to itself through its publications. I think there's an element of waste."

In dealing with complaints about waste and abuse in the System, Mr. Greenspan has apparently resorted to the simple tactic of "stonewalling" in some cases.

On January 8, 1996, Representative Henry Gonzalez, the Ranking Democrat on the House Banking Committee, submitted a 41-page report to the Federal Reserve citing "waste and abuse" in the operation of the agency's system for clearing and collecting checks.

The study, conducted by Dr. Robert Auerbach, the Democratic Staff Economist, detailed improper contracting practices, gifts to nonperforming contractors, overcharges to the U.S. Treasury, violations of the Monetary Control Act of 1980, and lack of controls over contracts for transporting checks across the Nation in fleets of planes nightly. Backing up the allegations of waste and questionable practices were signed statements from employees in the Interdistrict Transportation System operated in the Federal Reserve Bank of Boston, Representative Gonzalez told Chairman Greenspan. Was Mr. Greenspan concerned? Apparently not since Representative Gonzalez has yet to receive a reply—even an acknowledgment—to the report.

Mr. Chairman, I would like to submit a copy of the Gonzalez report for the record so that this Committee will have an idea of how much concern the Federal Reserve places on waste and abuse in the System. Before this Committee votes on the Greenspan nomination, it should have an answer on this issue. A charge of waste of public monies by a Ranking Member of the House Banking Committee should at least have an answer, if not a remedy.

Consumer Issues

Under Alan Greenspan, the Federal Reserve Board is essentially passive on consumer issues. If Congress gives the agency a consumer law to enforce, it will go through the motions. But rarely does the Fed knock on the doors of the Legislative Branch for solutions to consumer problems or put up battles to keep the banking industry from weakening existing protections. And even rarer are initiatives in utilizing existing powers to give consumers a fair break in the marketplace.

A prime example was in the news last week when the Federal Trade Commission announced it was launching a major effort to fight scam artists who are using "demand drafts" to rob consumers' bank accounts of tens of millions of dollars annually. The victims were consumers who had given out their bank account numbers and permission to use demand drafts for magazine subscriptions, various membership fees, and similar outlays.

To make the scams work obviously required wide utilization of the banking system—right where the Federal Reserve's authority lies. But, it was left to the Federal Trade Commission, not the well-staffed and well-financed Federal Reserve System to take aggressive action to protect the consumer—even though the Federal Reserve shared identical enforcement power with the FTC under Section 18(f) of the FTC Act.

When the contest over consumer regulations is between consumers and the banking industry, the Federal Reserve can find some creative ways to support the industry. The Congress, for example, recently asked the Federal Reserve to give it a report on regulations to limit the time that banks may hold checks before crediting the consumers' account. In answer to the Congressional request, the Federal Reserve decided to survey the banks and prepared a one-sided questionnaire that assures the results would be weighted to the banks' desire to lengthen the time they could hold checks.

The survey allows the banks to "estimate" their check losses instead of providing hard data—an open invitation for banks to exaggerate losses. And participation, the Federal Reserve decided, would be "voluntary." This means that the returns are likely to be heavier from those institutions most actively seeking changes in the checkhold law, rather than providing representative data for a cross section of banks.

The message for consumers from the Greenspan Federal Reserve: Don't expect pro-active steps for consumers by the Federal Reserve and don't expect to win a battle with the industry over regulations when the Federal Reserve is the referee.

The Fed's implementation of the Equal Credit Opportunity Act (ECOA) provides a good example of the Fed's regulatory inertia when it comes to consumer, community, and civil rights interests. Although ECOA prohibits credit discrimination against small businesses as well as consumers, the Federal Reserve has never established any disclosure requirements that would permit monitoring of discrimination against small businesses. Indeed, the Fed's Regulation B, which implements ECOA, perversely prohibits lenders from collecting data on the distribution of their small business loans by race category.

Civil rights organizations, community groups, and even the Clinton Administration have asked the Federal Reserve to revise Regulation B to require lenders to collect and make public race data on their small business lending patterns. Under strong pressure from the Clinton Administration, the Fed in April 1995 proposed to modify Regulation B to permit voluntary collection of race data on small business loans and other types of credit. Yet, one year later the Board has failed to act on even this extremely modest proposal.

Similarly, the Federal Reserve is looking the other way on the convenience and needs of communities as mergers sweep across the Nation. Neighborhoods and communities are facing the loss of banking facilities, while borrowers in low- and moderate-income and minority neighborhoods, already starved for credit, are seeing lending decisions moved through distant lines of management in these new merged giants.

Eight hundred community organizations turned out on the West Coast to oppose the Wells Fargo-First Interstate merger on the grounds that the closure of 345 branches would severely wound local communities. The Federal Reserve heard the arguments and received the documentation, but in the end the wishes of Wells Fargo were granted—and the 345 branches will be closed.

Interstate branching and the vast increase in mergers is creating a new generation of problems for communities—but the Federal Reserve is not meeting its responsibility to examine fully the convenience and needs of communities as required by the Bank Holding Company Act.

Dissent—Is It Allowed On The Greenspan Board?

Are strong independent voices excluded from Greenspan's Federal Reserve Board?

Alan Blinder, the Vice Chairman appointed by President Clinton, unexpectedly resigned and returned to his job at Princeton, removing a voice from the Board for more openness and more concern about employment and consumer issues than may have been compatible with the Greenspan party line. And there were published reports (including one in the Columbia Journalism Review) that Greenspan's staff had leaked unflattering comments to the media that led to stories that Blinder was "soft on inflation"—an episode that undoubtedly increased Blinder's frustration and desire to leave the Greenspan Board.

President Clinton's choice for Blinder's replacement was Felix Rohatyn, a New York investment banker, with a reputation for strong stands on economic issues and a belief in pro-growth monetary policy. After the opposition rose, including some from Members of this Committee, Rohatyn's name was dropped and the possibility of counterweight to Greenspan's conservative views was removed.

Two years ago, Dr. Alicia Munnell was slated for a spot on the Federal Reserve Board. But as an employee of the Federal Reserve Bank of Boston she had conducted a significant study on discriminatory lending patterns by commercial banks—and this gained her the lasting enmity of the banking industry, a fact that probably reduced her chances for a spot on the Board.

Conclusion

The public interest would be served by a change in the Chairmanship of the Federal Reserve Board. Alan Greenspan has served two full terms, stretching back to President Ronald Reagan's Administration and including a reappointment by President George Bush. No other head of a major Federal agency today has served longer than Alan Greenspan. As an agency cloaked in secrecy, term limits make particular sense.

Many of the problems I have cited were not invented by Alan Greenspan. But, he has done little to correct shortcomings and institute change that would open up the Federal Reserve and make it a more response agency subject to the checks and balances of a democratic system.

While the consensus is for approval of the President's choice, I urge this Committee to defer action until it has an opportunity to fully explore Alan Greenspan's ad-

ministration of the Federal Reserve Board. The confirmation process gives the Senate this opportunity and it should not be bypassed for the Federal Reserve.

In addition to his monetary policy duties, Alan Greenspan is also charged with major responsibilities in the area of bank supervision. His earlier confirmation hearings have failed to explain fully his role as a consultant to a number of savings and loan associations including the ill-fated Lincoln Savings during the 1980's and his battle against Federal Home Loan Bank Board Chairman Ed Gray's efforts to curb the investment powers of Lincoln Savings and other savings and loans.

The exhibits of the Special Counsel to the Senate Ethics Committee in the investigation of the five Senators involved with Lincoln Savings contain a number of letters, billings, agendas, and other items related to Alan Greenspan's activities during this period. Among these is an endorsement by Mr. Greenspan of Lincoln Savings as a "financially strong institution that presents no foreseeable risk to the Federal Savings and Loan Insurance Corporation" contained in a letter of February 13, 1985 to Thomas J. Sharkey, Principal Supervisory Agent of the Federal Home Loan Bank of San Francisco. These materials do not reflect the mind of a financial industry leader who weighs heavily the integrity of a financial institution, effective Government regulations, and protection of taxpayer interests.

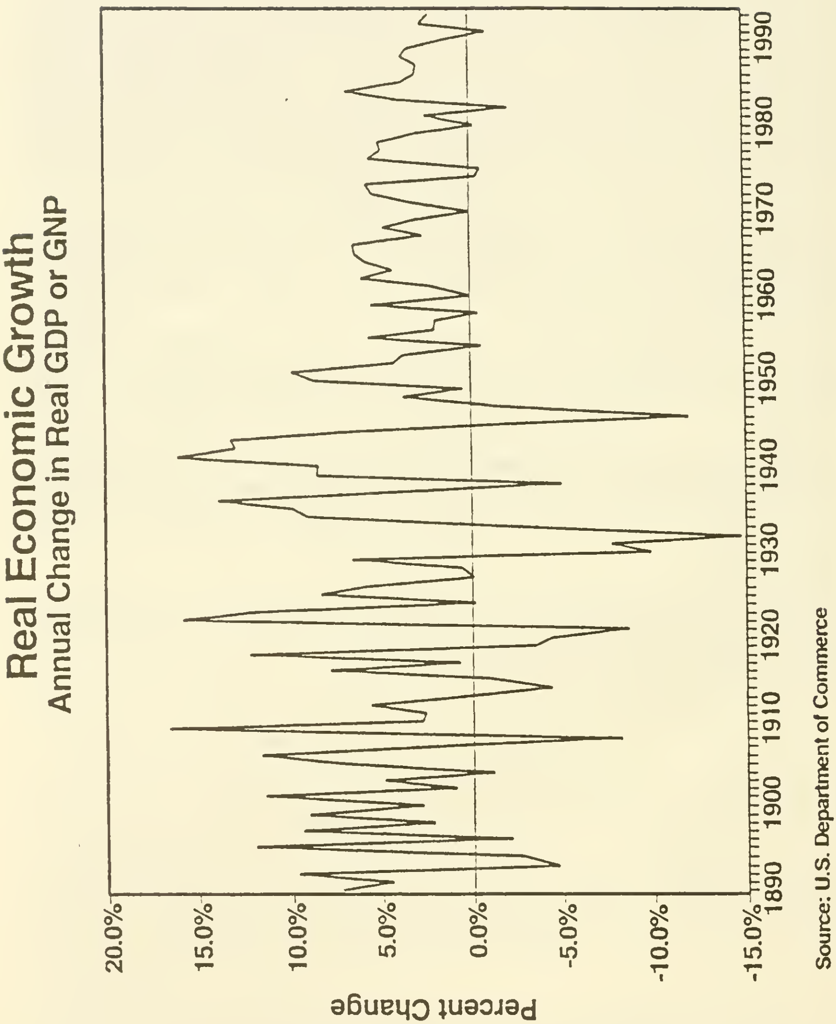
In light of the large regulatory role of the Federal Reserve, it is pertinent for the Committee to examine this area and determine whether Alan Greenspan's approaches to the savings and loan problems in the 1980's reflect an insensitivity to the overriding need to protect the deposit insurance funds and the taxpayers who have paid for several hundreds of billions of dollars of losses, including at least $2 billion in the failure of Lincoln.

[And on the question of deposit insurance currently, it would be interesting to know where the Federal Reserve Chairman stands on the decision of the Federal Deposit Insurance Corporation (FDIC) to cap the reserves of the Bank Insurance Fund (BIF) and allow the majority of banks to pay no premiums for Government insurance.]

Beyond these issues, it is important for this Committee to insist on changes at the Federal Reserve as a condition for confirmation—particularly changes that would remove some of the thick walls of secrecy that separate the agency from the people and the Congress. If Alan Greenspan is confirmed, he will control the Federal Reserve into the Year 2000. It is unlikely that there will be change in the agency unless the Committee insists on it now.

Thank You.

[Additional attachments supplied by Mr. Nader will be held in Committee files. The cost to reproduce these documents would be prohibitive and when reduced to fit page format the documents would be illegible.]


Real Economic Growth
Annual Change in Real GDP or GNP
Percent Change
20.0%
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
Source: U.S. Department of Commerce

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN

April 11, 1996

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
Washington, D C. 20548

Re: Draft report of the General Accounting Office entitled "Federal Reserve System. Current and Future Challenges Require Systemwide Attention," prepared pursuant to the request of Senators Harry Reid and Byron Dorgan.

Dear Mr Bothwell

The Board of Governors takes exception to the broad implication of the draft report that the Federal Reserve has not exercised appropriate budget constraint and that it has not adequately addressed the changing technological and financial environment within which it operates.

We at the Federal Reserve recognize that expending taxpayers' funds outside of the appropriations process places a special obligation on us to be particularly diligent in the use and application of such funds. We believe our diligence has resulted in a level of cost effectiveness and performance that equals that of the most efficient public and private sector institutions.

In order to fulfill its mandates, the Federal Reserve has had to undertake significant and often costly new initiatives since 1988 (the starting point of the GAO analysis) Among others, these have included the expanded supervision of U S. operations of foreign banks and a major upgrading of our computer systems and personnel to adapt our surveillance and payment technologies to the major changes that have occurred in private financial markets This upgrade involved significant consolidation within the Federal Reserve System, but it also enhanced our ability to ensure the smooth functioning of our financial markets, even during periods of financial or operational disruptions. To hold the risk of systemic crises to acceptably low levels for both U.S. markets, and U.S dollar markets abroad, requires some redundancy of resources We believe that the

benefits of this redundancy far exceed the associated incremental costs. In light of these initiatives, as well as others required by the Financial Institutions Reform, Recovery and Enhancement Act (1989) and the Federal Deposit Insurance Corporation Improvement Act (1991), we believe the control of our operating costs has been very effective.

Federal government non-defense discretionary expenditures, which the GAO draft report employs, is particularly useful as a rough standard of comparison, as these expenditures have been subject to increasing Congressional restraint in recent years. During the fiscal years 1988 to 1994, these costs increased 50.9 percent. Over the same years, despite the very considerable expansion of the Federal Reserve's role, our costs (on a calendar-year basis) increased 47.6 percent. Similarly, over this period, non-defense executive branch civilian employment grew by 5.5 percent compared to an increase in total employment at the Federal Reserve of 3.7 percent.

As further evidence of effective cost control, the Federal Reserve's provision of financial services to depository institutions in a competitive market (accounting for about one-third of Federal Reserve costs) has consistently earned money for the Treasury by recovering not only its direct and indirect costs, but also a rate of return and imputed taxes commensurate with our competitors in the private sector.

Nonetheless, the Board recognizes that the Federal Reserve System, like any organization, can be made more efficient and effective. The GAO draft report does include some specific recommendations regarding the management of certain costs that we consider potentially quite helpful and that we will evaluate and implement where appropriate. We will also continue to identify other opportunities to contain costs, while end avoring to carry out our mission in a effective manner.

One difficult issue that has and will confront the Board in our oversight of the System is the appropriate degree of consolidation of various activities. Certain Systemwide activities do appear to be more cost effective if consolidated. But it is also evident that the element of autonomy that is accorded to the Reserve Banks has created a competitive environment within the Federal Reserve that attracts highly qualified staff who contribute importantly to the effectiveness and efficiency of the Federal Reserve System over the long run The advantages of this environment must be balanced against the expected savings from consolidation

Our responses to a number of the specific GAO recommendations and observations are included in an enclosure to this letter

Sincerely,

Enclosure

Board of Governors of the Federal Reserve System
Comments on GAO Draft Report
"Federal Reserve System: Current and Future Challenges Require Systemwide Attention"

The Federal Reserve's Role in Providing Financial Services

The draft report recommends that the Board undertake a fundamental review of the Federal Reserve's role in providing financial services to banks and government agencies.

Such reviews are an ongoing and integral part of our oversight of the Federal Reserve System. Moreover, it is important to recognize that the Federal Reserve's financial services and, in particular, its priced services, are continually tested by the marketplace. Institutions choose payments service providers based on the cost and quality of the alternative services available to them. The Federal Reserve Banks have been successful in providing services that are attractive to their customers by controlling costs while maintaining high quality standards.

The Federal Reserve fully recovers its cost of providing services to depository institutions over the long run. The Monetary Control Act (1980) requires that the Federal Reserve set fees for priced services to recover not only all direct and indirect costs incurred in providing the services, but also imputed costs, such as taxes that would have been paid, and the return on capital that would have been earned, had the services been provided by a private business firm. Over the past ten years, 1986 through 1995, the Federal Reserve Banks have recovered 101 percent of their total costs of providing priced services, including the targeted return on equity and other imputed costs.

Because the revenue from the Reserve Banks' priced services recovers imputed costs that are not actually incurred, the Federal Reserve's provision of priced services has consistently had a positive effect on the level of earnings transferred by the Federal Reserve to the Treasury. Over the past ten years, priced services revenues have exceeded operating costs by more than $872 million. Priced services revenues exceeded operating costs by more than $570 million during the period 1988 through 1994 reviewed for this draft report. This net revenue contributes to the amount transferred to the Treasury.

As acknowledged in the draft report, the Federal Reserve has a strategic focus for its financial services activities. The mission of the Federal Reserve in the payments system is to foster the integrity, efficiency, and accessibility of U.S. dollar payments and settlement systems in support of U.S. financial stability and economic growth in a global context. The Federal Reserve pursues this mission through a combination of the financial services provided by the Reserve Banks, the policies and rules adopted by the Board, and the leadership in financial markets exerted by the Federal Reserve on a variety of payments-related matters.

This strategic focus includes an ongoing assessment of the appropriate operational role of the Federal Reserve in the payments system The Board has adopted guidelines to evaluate both the Reserve Banks' introduction of new services and their withdrawal from existing services. The Federal Reserve's ability to recover the costs of providing priced services over the long run is an important consideration in assessing its future operating role. For example, in 1993 the Reserve Banks withdrew from the priced definitive securities safekeeping service, which had been subject to rapidly declining volumes due to the issuance of new securities in book-entry rather than physical form and the banking industry's increasing use of private depositories.

The Reserve Banks' check service has also been subject to volume declines. These declines are attributable largely to the same-day settlement rule adopted by the Board. This rule improves payments system efficiency by increasing the legal rights of correspondent banks that compete with the Reserve Banks in the check collection business. Although the Board anticipated that the rule would erode the Reserve Banks' check volume, it adopted it as being in the best interest of the payments system. The Reserve Banks have taken steps to reduce substantially their operating costs during the past several years in response to these volume declines. For example, during the 1993 through 1995 period, the Reserve Banks reduced check staffing levels by almost 600 employees, or by more than 10 percent. Additional staff reductions are planned for 1996. It is reasonable to expect that reductions in Reserve Bank resource levels would follow, rather than be contemporaneous with, significant volume declines

The Federal Reserve's strategic focus has also resulted in the re-engineering of the manner in which it provides many of its financial services and the implementation of other productivity improvements. For example, the Reserve Banks are centralizing the processing of their electronic payment services; centralization of Fedwire funds transfer processing is substantially completed and centralization of the ACH and Fedwire book-entry securities transfer applications is underway. As part of this initiative, the Federal Reserve has significantly enhanced the level of contingency backup of its critical applications, including Fedwire. High operational reliability of the Fedwire applications is especially critical to the continued smooth functioning of the financial markets due to the value of transfers processed, which is currently $1 5 trillion per day.

The Reserve Banks have also sought ways to improve the efficiency of their paper-based services. They have consolidated processing of their noncash collection service for maturing coupons and bonds from 27 to 2 sites, and also have consolidated their savings bond operations by reducing the number of sites from 24 to 5 Moreover, they have sought to improve the efficiency of the check collection process by promoting electronic check presentment and have significantly improved the efficiency of their ACH service by accepting ACH transactions from, and delivering transactions to, all depository institution endpoints electronically. Finally, the Federal Reserve, working with the Treasury, has introduced automated processing to the previously paper-based Treasury auction system, improving the accessibility, integrity, and timeliness of the Treasury securities auction process The Reserve Banks are currently consolidating the handling of commercial tenders from 13 to 3 sites using this automated system

These and other changes have improved the reliability and security of many Federal Reserve services and have enabled the Reserve Banks to respond more quickly to changes in business requirements. At the same time, many of the initiatives described above have resulted in one-time transition costs. Nevertheless, the Reserve Banks have been able to contain the aggregate unit cost of providing financial services. While the quality of Federal Reserve services has improved, the cost per transaction of providing all of these services has increased far less than the rate of inflation. Moreover, we expect the unit cost of our electronic payment services to decline as transition to the centralized environment is completed.

The draft report recommends that the Federal Reserve's review of its role in providing financial services include its role in providing services to the government. As fiscal agents of the United States, the Reserve Banks do not dictate the scope of their role in providing fiscal and depository services to the federal government. Instead, the Reserve Banks provide financial services to the government at the direction of the Treasury and other federal agencies. We endeavor to provide high-quality, cost-effective services to the federal government and work in concert with the Treasury and other federal agencies to achieve this objective. Several of the examples noted above illustrate some of the efficiency and quality initiatives undertaken by the Federal Reserve in its role as fiscal agent. We are also continuing to work closely with the Treasury to determine how the federal government can best meet its future payments and debt processing needs.

Management Structure and Consolidation of Operations

The draft report recommends that the Board assess the cost saving opportunities that could result from streamlining the Federal Reserve's existing management structure and consolidating operations, including the possible merger of some of the 12 Reserve Banks and 25 branches

We agree that it is important that the Federal Reserve assess how it can best fulfill its mission, particularly given the evolution in technology, banking structure, and consumer demand for financial services. As discussed above, the Federal Reserve has consolidated or is planning to centralize or consolidate the provision of many of its financial services. In addition, System staff is currently evaluating possible infrastructure changes that may have the potential to increase the efficiency of the Reserve Banks' check and cash services. Our analyses suggest that significant scale economies exist in electronic payment functions, with much more modest economies of scale apparent in paper-based systems. Further, as long as currency or checks are physically transported to and from depository institutions, proximate physical location will continue to be important in providing these services.

While the location and territory of some of the 12 Federal Reserve Bank head offices and their 25 branches would likely be different if they were established today, relocation of facilities or substantial realignment of office territories generally is very costly, and the long-term savings would have to be substantial to offset the transition costs

The Use of Technology to Streamline Work Processes

The draft report recommends that the Board assess the potential for technology to support streamlined work processes in the Reserve Banks, reduce costs, and improve quality.

We agree that an ongoing assessment of technologies is essential in identifying possible means of improving operations; the Federal Reserve has a long-standing position of leadership in developing and applying technology in the financial sector. We routinely assess technologies for their ability to reduce costs and improve quality, reliability, contingency backup, security, risk control, and customer service.

To advance these goals, some initiatives taken during the period covered by the draft report include the consolidation of Reserve Bank mainframe processing at Federal Reserve Automation Services (FRAS), the implementation of a new unified communications network, Fednet, which connects the Federal Reserve offices and approximately 13,000 depository institution endpoints, and the development and implementation of the National Information Center (NIC), a central repository for bank structure, financial, and supervisory information on all domestic and foreign banking organizations with a U.S. presence. The NIC facilitates the monitoring and analysis of individual organizations as well as of the banking industry as a whole and helps us streamline and enhance the effectiveness of our supervisory activities. Although expenses have been incurred exclusively by the Federal Reserve, the NIC system is available to other federal regulators and to state banking agencies.

In addition, the Federal Reserve provided the research and development that was critical to the development of high-speed check image capture capability. Moreover, together with the Treasury, the Federal Reserve has developed and implemented sophisticated currency counterfeit-detection processes and systems. The Federal Reserve has also implemented FED-Mail, which provides a more cost-effective and timely electronic delivery mechanism for the dissemination of information to depository institutions.

These are but a few examples of the Federal Reserve's application of technology to improve the security, quality, and cost effectiveness of its operations.

Control and Oversight Mechanisms

The draft report concludes that the combination of the Board's general supervisory responsibilities for Reserve Bank operations and the autonomy of the Reserve Banks has resulted in oversight that, in some cases, appears fragmented, inefficient, or lacking in independence. The draft report indicates that the GAO found issues that were either not adequately covered or were reviewed by both the Board's and the Reserve Banks' oversight organizations.

The Federal Reserve's audit structure has long proven to be very effective Audit coverage for Federal Reserve Banks is multi-faceted and appropriately reflects the structure of the Federal Reserve System and the statutory roles of the various entities and their respective auditors. The different audit approaches result in a thorough and balanced perspective of the entire Federal Reserve environment. Each of the responsible entities (Federal Reserve Banks and Board of Governors) has its own independent auditing function reporting to its respective board

The Reserve Banks have adopted and follow the Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing, the world-wide standard for the internal auditing profession. The internal auditors of each Reserve Bank report to the audit committee of that Bank's board of directors. Consistent with current business practice, all audit committee members (in fact, all members of the boards of directors) are outside directors who are independent of management. The audit committee selects the Bank's General Auditor, approves the annual audit plan, budget, and staffing level, and evaluates the General Auditor's performance. In addition, the General Auditors provide information about audits and miscellaneous items to the Board of Governors at least quarterly.

The draft report notes potential overlap of audit coverage, citing the audit attention to FRAS as an example. The FRAS auditing for the System is overseen by the Conference of General Auditors (COGA), which is comprised of the General Auditor of each Reserve Bank and a Board liaison, and is administered by the Richmond General Auditor, because FRAS is part of the Richmond Federal Reserve Bank. While audits are performed by Richmond's internal audit function and by the Board's financial examiners, each party carefully plans its audit work to avoid unnecessary duplication The Board's Inspector General (IG) also reviewed the effectiveness of the Board's oversight in this area

Moreover, each Reserve Bank is also examined by the Board's financial examiners, who report to the Board of Governors. The financial examination program is an essential part of the statutory scheme for the oversight structure of the Board of Governors for the Reserve Banks The Board is responsible for assessing financial, operating, and procedural controls as well as reviewing the efficiency of Reserve Banks and the quality of their services. This Board-based examination program provides a centralized focus. The Board also engages an outside audit firm to conduct audits and certify the combined financial statements of the Reserve Banks, a step that the GAO draft report commends

The GAO draft report recommendations for addressing its concerns in this area include taking steps to better assure the independence of its internal audit function, and extending the IG's authority to include responsibility for auditing Reserve Bank and Systemwide projects. We believe that the audit process described above, including the use of outside audit firms, assures adequate independence We believe that extending the IG's authority would not improve the audit focus and would be less desirable than the current audit approach. For example, if the IG becomes an integral part of the Board's oversight process, it would lose its "arms length" ability to audit such processes

Budget Process

The draft report indicates that the Federal Reserve's budget process has weaknesses in that it uses a current services approach that assumes that existing functions would be retained and continued through incremental budgetary growth. The draft report also indicates that this approach provides inadequate support to top management in constraining costs and imposing internal self-discipline necessary for the Federal Reserve to respond effectively to future priorities.

The Federal Reserve's budget process does not use a current services approach. The Reserve Bank and Board budgets are strategy-driven and reflect a decision-making process that focuses on priority setting, continual re-examination of the need for existing programs, and phasing out activities and processes as appropriate. As previously discussed, many changes have occurred in Reserve Bank operations during the period covered by this draft report. In addition, the Federal Reserve has actively engaged in improving the efficiency of its output services as well as its support and overhead activities. Moreover, as the GAO correctly states, a significant portion of the increase in Federal Reserve expenses has been the result of legislative mandates in the supervision and regulation area, such as the Financial Institutions Reform, Recovery and Enhancement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act, including the Foreign Bank Supervision Enhancement Act, which have had a major impact on Federal Reserve System expenses.

The budget process used by the Federal Reserve System focuses on a number of factors, including workloads associated with volume projections, the effect of legislation on the scope of the Federal Reserve's responsibilities, the use of technology, and projected changes to pay, benefits, rents, travel, and other costs. This process is reflected in the variations among the individual Reserve Bank and Board budgets and the significant re-engineering of work processes and downsizing of selected functions that has taken place. As noted earlier in our response, some functions have been eliminated or consolidated to improve quality, consistency, and efficiency. Such downsizing and re-engineering is not indicative of a current services budgeting approach

Finally, it should be noted that the Federal Reserve budget process is but one part of a larger process The System engages in strategic planning; the strategic plans are reviewed each year with a view to ascertaining whether the strategic directions are still appropriate. Strategic plans are then implemented through action plans and annual objectives Our, or any other, strategic planning process can be continually improved, and we are in the process of doing that, as is discussed below. But we believe that this forward-looking planning process helps ensure that our activities, be they monetary policy, bank supervision, or financial services, will continue to best serve the public's needs.

Federal Reserve Pay and Benefit Levels

The draft report recommends that the Board review pay and benefits levels at the Board and the Federal Reserve Banks to determine if current levels can continue to be justified in today's environment of increased governmental and private-sector cost containment. It also recommends that the Board assess whether managing the System's health care coverage on a Systemwide basis could reduce health care costs.

In order to acquire and maintain personnel with the degree of skills necessary to accomplish our mandate, the Federal Reserve strives to provide salaries and benefits competitive with local private-sector markets. We use a number of approaches to evaluate our compensation programs, including participating in local and national salary surveys, contracting with compensation consultants, and using published wage data. Our analysis of this information indicates that Federal Reserve System base pay generally is competitive at non-officer employee levels with the average base pay of comparable positions in our local labor markets. Base pay lags the market, however, for certain positions, including Federal Reserve System senior level officers and, in terms of total compensation (i.e., base pay plus other forms of cash including bonus and incentives), most Federal Reserve officer levels lag the market, some very significantly. Our presumption is that for our officers the nonmonetary rewards of working in the Federal Reserve System compensate for the often significantly higher monetary compensation available in the private sector.

The draft report indicates that the increase in Federal Reserve benefits from 1988 to 1994 was significantly higher than that of the federal government. This does not appear to be the case. As noted in the draft report, the Reserve Banks monitor and control costs computed on an accrual basis rather than the cash basis used by the federal government. Particularly as it relates to retiree benefits, the cash basis of accounting is clearly an inferior accounting methodology to the accrual basis. Because we are unable to adjust federal government benefits to an accrual basis, in an effort to facilitate a comparison, we have reversed the most significant accruals in the Federal Reserve accounts.[1]

After adjusting for these accruals, the cost of benefits per employee for the Federal Reserve and the federal government increased by approximately the same percentage during the 1988 to 1994 period; i.e., 64 percent and 62 percent, respectively. Based on this adjustment, the increase in total compensation per employee for the Federal Reserve also appears to be similar to that of the federal government for the period reviewed in the draft report.

The Federal Reserve continually assesses Federal Reserve benefits to identify benefit design, cost containment, and productivity enhancements. As a result of these and other efforts, we have implemented effective cost containment techniques, such as managed care medical programs, which were introduced some years ago. As part of this ongoing effort, we will continue to explore whether managing some parts of our health care programs on a Systemwide

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[1]Specifically, we reversed the effects of Financial Accounting Standards (FAS) 87 and FAS 106 on the Federal Reserve's calculated cost of benefits

basis, as the GAO draft report suggests, would improve efficiency and reduce costs, while retaining the quality of these benefits.

The draft report also states that "a few Federal Reserve benefits are more generous than those available to the OCC and FDIC and many are more generous than civil service benefits, such as those available to SEC." We believe that the comparison of overall benefit costs cited above is more meaningful. Nevertheless, with respect to specific benefits, the FDIC pays more for health insurance premiums per capita than the Federal Reserve; the FDIC and OCC provide greater dental insurance subsidies; and the OCC and FDIC contribute more to employees' savings plans.

In addition, the draft report highlights six Federal Reserve benefits as being more generous than civil service benefits, but we believe several of these comparisons are misleading. The Federal Reserve contributes less to its employees' savings plan than the Federal government under FERS, and many federal agencies also offer mass transit subsidies to their employees. Although the Federal Reserve offers premium conversion accounts and flexible spending accounts, the contributions to these accounts are made by employees and the Federal Reserve incurs only a small administrative cost in providing the services

Surplus Account

The draft report states that a reduction in the Federal Reserve's surplus account would have a positive effect on the federal budget by increasing the amount returned to the Treasury in the years the reductions occur Therefore, the report recommends that the Board assess whether there is any compelling need for the surplus account, and whether the size of the account can be safely reduced

We agree that the appropriate level of the Federal Reserve surplus is open to debate. But consideration of the surplus should recognize that its transfer to the Treasury would have no meaningful effect on the gap between receipts from, and outlays to, the general public -- that is, it would have no economically relevant meaning for the federal budget deficit in this context. Moreover, reducing the Federal Reserve surplus to very low levels or eliminating it could have certain disadvantages.

To be sure, transferring the approximately $4 billion surplus to the Treasury would increase "unified receipts" and reduce the "unified budget" deficit, as these measures have been defined for budget accounting purposes. The Treasury would have $4 billion less in debt outstanding, and its gross interest payments would drop by the interest on that debt But this is an artifact of an accounting convention, and does not represent a change in the government's true economic and financial position These are intra-governmental transfers The Federal Reserve holds government securities as the asset counterpart to the surplus in its capital accounts, interest on which it returns to the Treasury. If the Federal Reserve decreases its surplus by $4 billion it would have to decrease its government security holdings by the same $4 billion. Consequently,

the Federal Reserve's payment to the Treasury would decline into the indefinite future by the amount of interest on the $4 billion, exactly offsetting the Treasury's savings on gross interest payments. The debt in the hands of the public (excluding the Federal Reserve) and consequently the net interest cost to the Treasury of financing that debt would be unchanged.

Thus, transferring the surplus to the Treasury, to repeat, would be only an exchange of intra-governmental claims involving no net transactions with the public. Recognizing the anomaly between the accounting in the unified deficit and financial reality, Congress instructed the Congressional Budget Office not to count any transfer of Federal Reserve surplus as real deficit reduction for budget scoring purposes for FY 1996.

Moreover, using Federal Reserve surplus to finance government expenditures would have potential disadvantages. By law, Federal Reserve notes must be collateralized by specified types of assets, including gold, U.S. government securities, foreign currencies, and certain other instruments (though the Federal Reserve has raised questions about the economic rationale for this law). The margin of available collateral has shrunk over the years, partly reflecting the declining volume of reserve balances and the associated drop in Treasury securities corresponding to those balances. By reducing the Federal Reserve's holdings of government securities, a transfer of surplus would further narrow the margin of excess collateral. A sizable increase in any assets not eligible to serve as collateral -- such as loans to a troubled bank secured by the bank's loans -- could require the use of foreign currencies, which have seldom been used for this purpose in the past. In an extreme case, the Federal Reserve could have difficulty complying with the collateral requirement while conducting an appropriate monetary policy.

Finally, elimination of the surplus would increase the risk that a loss of asset value could seriously impair capital that has been paid in by member banks and possibly result in a negative capital position for the Federal Reserve. Although the Federal Reserve has never had an annual loss, it has had on many occasions short-run losses that have necessitated temporary withdrawals from surplus. The Federal Reserve publishes its balance sheet weekly, and therefore temporary capital impairment would be publicly known. The Federal Reserve's earnings would remain quite substantial, permitting its capital to be rebuilt fairly quickly, and, in principle, low or temporarily negative capital should have no adverse effects on the Federal Reserve's ability to meet its financial or public policy obligations. Nonetheless, such a situation could prompt questions in the minds of some investors in dollar assets, including holders of Federal Reserve notes, about the continued ability of the central bank to conduct a sound monetary policy. Even though such concerns would have little merit, if investors acted on them, real economic effects would be felt.

Charges for Bank Examinations

The draft report recommends that the Board reconsider its policy of not charging for bank examinations.

Although state examination fees are currently approximately half those of the OCC on average, the fact that there has been little shifting to state charters in recent years reinforces the view that national charters have superior franchise value for some banks. Interstate banking may increase this disparity. Accordingly, additional fees imposed by the Federal Reserve on state member banks, and presumably by the FDIC on state nonmember banks, could tip the scales further toward national charters, thus calling into question the long-term viability of a valuable dual banking system.

Contracting and Procurement Practices

The draft report states that the Reserve Banks could better ensure the purchase of goods and services at reasonable cost through increased compliance with their uniform acquisition guidelines and adoption of best practices in procurement and contracting.

We agree that Reserve Bank contracting and procurement practices should be reviewed to ensure that they are consistent with Federal Reserve policy and result in cost-effective contracts and we will strengthen our oversight in this area. While informal communications between Reserve Bank officials currently provide for the sharing of information on best practices in procurement and contracting, we will encourage the Reserve Banks to establish a more formal forum for exchanging this information.

Travel Policies

The draft report states that the Board's general policy directive for Reserve Bank travel expenditures allows for variations in Bank reimbursement procedures, which can result in unnecessary expenditures.

A recent Board survey indicates that, for the most part, the Federal Reserve Banks' and the Board's travel rules are consistent with General Services Administration travel rules. The Board's practice is to provide guidance to the Reserve Banks in areas such as travel, without providing rules on every detail of the Reserve Banks' operations. The Board requires that each Reserve Bank have a written policy regarding permissible expenditures for travel, including purpose, method, and class of travel. Travel policies may provide for a daily per diem allowance, for reimbursement of actual expenses, or a combination of the two. When provision is made for reimbursement of actual expenses, the provision should be in line with sound business judgment, community standards, and applicable Internal Revenue Code provisions. Explanations of any unusual and extenuating circumstances are required. Both the Reserve Banks' internal auditors and the Board's financial examiners review expenditures for their propriety and conformance with Bank and Board guidelines. We will review Reserve Bank travel policies to determine whether modifications indicated by the GAO draft report, or any other modifications, are warranted.

Management of Reserve Bank Building Projects

The draft report states that opportunities were overlooked to reduce the costs of the new Dallas Head Office building project and cited as examples the sizes of the overall building, the lobby, the computer facilities space, and the land on which the building is sited.

This building project was completed on time and $15 million under its original budget. This result was achieved in spite of the fact that the overall size of the building increased by approximately 35,000 square feet from the initial program to the final design approved by the Federal Reserve Board. The increase was due primarily to the need to enclose the delivery courts inside the building. The City of Dallas would not permit delivery trucks to maneuver on a city street and required that the maneuvering space be provided on the Bank's property. Because the building's floor plate occupied most of the 6.2 acre portion of the site dedicated to the building, the delivery courts were relocated inside the building.

The main lobby and exhibit space on the first floor comprise 6,671 square feet of floor area, which is less than the 7,800 square feet included in the initial program. The GAO also appears to be referring to the second floor corridor or hallway as lobby space. The second floor "lobby" is provided for employees entering the building from the parking garage and serves as a controlled entry and corridor to the building's elevators. This corridor leads from the elevators along the meeting rooms and assembly room to the cafeteria. As the design evolved, the corridor was widened, at a very low cost, to function as the main breakout area for the meeting and assembly rooms; this enabled the Bank to avoid building a dedicated reception area to accommodate large numbers of people.

During the planning and design phase of the building, the decision to consolidate Federal Reserve mainframe automation had not been made and the details on space needs were unknown. Although the initial program identified approximately 70,000 square feet of floor area for the Bank's computer services function, additional space was identified within the overall space program for the possible installation of a consolidated data center. This was accomplished by providing raised flooring on an additional floor to accommodate easy conversion of that space from office to data center space. When the building was later modified for one of the FRAS computer centers, that space was easily converted at a cost significantly lower than would have been the case otherwise.

Although the building plan was based on a site requirement of approximately 6.2 acres, parcels were not available in the configuration needed to develop the site. Therefore, it was necessary to acquire approximately 8.0 acres in order to obtain the necessary acreage. Siting of the building was carefully planned so that, in the future, if the property is not needed, it can be sold.

Systemwide Strategic Management Process

The draft report indicates that, if the Federal Reserve is to meet the challenges it faces and streamline operations effectively, the Board and the Reserve Banks must work together to plan strategically for the future.

The Federal Reserve System has engaged in strategic planning efforts for many years. As a result of plans and strategies developed from these planning efforts, we have successfully met significant challenges in supervision, financial services, and monetary policy. More recently, the Board established a System Strategic Planning Coordination Group consisting of selected members of the Board, Reserve Bank Presidents, and staff. As the name implies, the group provides a Systemwide focus for coordinating the forces affecting how the Federal Reserve can carry out legislated mandates and the most effective and efficient ways of meeting its public policy objectives into the twenty-first century. This group has a broad mandate, but it is important to note that it is only the latest manifestation of an ongoing process in the Federal Reserve.

Waste and Abuse in the Federal Reserve's Payment System

Prepared by the Democratic Staff
of the
Committee on Banking and Financial Services
Rep. Henry B. Gonzalez (D-San Antonio, Texas)
Ranking Democrat

ONE HUNDRED FOURTH CONGRESS

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This report has not been officially adopted by the Committee on Banking and Financial Services and may not, therefore, necessarily reflect the views of its members.

Contents

Summary

After receiving complaints about the Federal Reserve's operation of the U.S. payment system, U.S. Representative Henry B. Gonzalez, Ranking Democratic Member of the Committee on Banking and Financial Services, directed the Democratic staff of the Committee to investigate the Federal Reserve's Interdistrict Transportation System (ITS) which operates the Fed's paper check clearing services. The ITS contracts a fleet of airplanes and auxiliary ground services to transport paper checks to each respective Federal Reserve Bank for clearing. The ITS transports U.S. Treasury checks as well as private sector checks and charges for this service on a volume basis. The Federal Reserve is required by the Monetary Control Act of 1980 (MCA) to match its revenues with its costs over the long run so that the prices for the services it sells are not subsidized. Evidence gathered by the Committee in the course of this investigation suggests that the Federal Reserve is in violation of the Monetary Control Act.

The following summarizes additional problems the Committee found with the Federal Reserve's Interdistrict Transportation System:

<u>Explanation of the Interdistrict Transportation System</u>

The Federal Reserve Bank of Boston supervises the ITS, a multi-million dollar operation which contracts airplanes and ground services to transport checks across the country.

<u>Possible Violation of the Monetary Control Act</u>

The Federal Reserve may have violated the Monetary Control Act of 1980. This law requires the Federal Reserve to charge competitive prices by matching its costs and revenues for its priced services, thus permitting private enterprise to compete with commercial operations of the Federal Reserve. Although the Fed reported near 100 percent cost/revenue matching, the ITS staff stated its revenues accounted for only 80 percent of ITS costs for the past four years, or 75.5 percent if the FRBB had not collected extra revenue by overcharging the Treasury. ITS staff said they were ordered to manipulate the data to project higher cost/revenue ratios.

<u>Improper Contracting Practices</u>

The FRBB officers supervising ITS paid millions of dollars to private companies without any competitive bidding even though it has used competitive bidding for these contracts in the past. The Fed circumvented the competitive bidding process in some cases by making prior arrangements to pay favored, low bidders additional funds after the contracts were awarded. The ITS staff told the Committee it may have been supplied with a "bogus" bid to make it appear there had been competitive bidding for an ITS freight forwarding contract.

<u>"Gifts" to Nonperforming Contractors</u>

In mid-1995 the FRBB officers supervising ITS extended the contracts of three private carriers without competitive bidding. These extensions included payments for non-existent spare planes that were unavailable to ITS despite a contractual obligation. All of these contracts were

extended at substantially higher rates (5 to 11 percent higher than previous amounts), according to Federal Reserve officials. Two ITS staff members estimated a 14.57 percent increase for one vendor. Approximately $2 million of taxpayers' funds were paid for services that were, in large part, not rendered by private companies. For example, FRBB supervisors paid $66,146.92 to a private air courier company, North Coast Aviation (NCA), after it had received a final grounding order from the Federal Aviation Administration (FAA) for numerous safety violations and for allegedly falsifying aircraft identification numbers to avoid mandatory maintenance. The Committee has reviewed dated invoices from NCA which show that it received four weeks of payments for services it did not perform. Additionally, ITS personnel said they were ordered by their supervisors to make the payments despite the knowledge that the invoices were incorrect.

Federal Reserve Overcharging the U.S. Treasury

The FRBB has been improperly charging the U.S. Treasury 67 percent more than it charges private sector companies for transporting canceled Treasury checks, costing taxpayers millions of dollars. The Committee has discovered that this discrepancy between the rate the Fed charges the Treasury and what it charges private companies, was not known to Treasury officials.

Insufficient Controls, Waste and Deception

The ITS engaged in budget dumping by making lump-sum payments to contractors toward the end of the year for future services. (This practice allows the ITS to falsely justify its funding in subsequent budgets.) In one case $700,000 was paid to a private company that failed before it performed approximately $420,000 in services. FRBB officials made no attempt to recoup this loss from the company during bankruptcy proceedings.

The Committee staff found that there were insufficient controls to account for approximately 6.5 million gallons of fuel provided annually by ITS at no charge to its contracted private aircraft companies. ITS personnel said the Federal Reserve could not account for *at least* 200 gallons of jet fuel per carrier per week. The FRBB furnished the Committee with a letter from a private vendor to an FRBB officer thanking the FRBB for agreeing to supply ITS fuel for a private non-contracted use. The date on the letter supported the Fed's contention that there was no prior plan to furnish ITS fuel for the unauthorized use; that it was just a "spur of the moment" decision when the network started. The Committee obtained a duplicate letter written to the FRBB by the private vendor with a date two weeks earlier, a letter the FRBB had failed to send when all such communications were requested by the Committee staff.

The Federal Reserve paid nearly $400,000 in 1993 to a private consulting firm, Arthur D. Little, Inc., to study ITS operations and provide recommendations. The consulting firm produced a short report and computer software. According to FRBB officers and ITS staff who operate the ITS, the report and recommendations were said to be of little or no use in the operation of the ITS and the software was useless because it was incompatible with FRBB software.

Conclusion

When the Committee brought this egregious waste to the attention of the FRBB, their

response was, "it's a difference in opinion about management decisions," and little effort has been made to correct these problems. While the Fed may dismiss millions of dollars as "peanuts," American taxpayers may not.

1.) Interdistrict Transportation System

Clearing paper checks: The Federal Reserve's Interdistrict Transportation System (ITS) office at the Federal Reserve Bank of Boston contracts a fleet of 47 airplanes and auxiliary ground services that transport an average of $10 billion in canceled paper checks across the country each night, Monday through Thursday. The ITS handles checks cleared between Federal Reserve Banks, both those initially cleared and those that have been returned for insufficient funds. ITS planes make approximately 200 flights nightly, Monday through Thursday, with some additional weekend flights. The ITS also contracts with freight forwarders which are companies that transport checks for ITS on Tuesday through Friday mornings using commercial airlines. The freight forwarders transport the checks via private air freight carriers. In 1994, the Federal Reserve spent $35 million on its ITS operations.

Since 1991, Santa Express, a private company, has had only one customer, the Federal Reserve. At its headquarters in Duxbury, Massachusetts, Santa Express operates the ITS central control facility which monitors and directs the transportation of checks each night. Santa Express also provides for the loading and unloading of ITS contracted aircraft at airports in the network that are called "hub cities." The contracted air carriers provide their own loading and unloading services at other airports.

Interdistrict Transportation System (ITS) Hub Cities and Airports

(There are 43 spoke cities)

HUB CITY	AIRPORT
New York	Teterboro (in New Jersey)
Cleveland	Burke-Lakefront
Atlanta	Hartsfield
Chicago	Midway
Dallas	Love

Example: To illustrate ITS operations, consider a check paid by a New York City resident for a purchase in Los Angeles, California. The check is deposited in a Los Angeles bank which may clear it by sending it to the Los Angeles branch of the San Francisco Federal Reserve. The Los Angeles branch sends the check via ITS aircraft to the Federal Reserve Bank of New York which sends it to the New York City bank on which it is drawn. If there are insufficient funds, the check must be sent back across the country. Any delay in processing the checks results in float. Float arises because the money designated on a check is simultaneously recorded in two different accounts: the money is credited to the account where the check is deposited even though the funds have not yet been deducted from the account at the bank where the check is drawn.

Federal Reserve Officials Supervising ITS: The immediate supervisors are officers of the

FRBB. The First Vice President of the FRBB responsible for ITS operations is Paul M. Connolly. The vice presidents in charge of ITS operations were Robert LaRocca (1983 through late 1993, after which he was promoted to senior vice president) and Richard Burns (1993 to present). FRBB Vice President and Associate General Counsel John Kimball also was responsible for overseeing ITS. Mr. Kimball met with Committee staff while they examined ITS documents at the Board of Governors in Washington, D.C. and actively participated in the June 26, 1995 interviews at the FRBB.

At least several employees of the Board of Governors involved with the operation of the Federal Reserve's payment system including ITS operations, are knowledgeable about Congressman Gonzalez's investigation. Several of these individuals spoke with Committee staff about the investigation. Jack Walton, Manager of Check Payments at the Board of Governors, was present at the June 26, 1995 Committee staff interviews at the FRBB. At that time he indicated he was investigating matters connected to the Committee investigation. He said he had recently been to the Santa Express Duxbury, Massachusetts headquarters which operates the nightly central control functions for the ITS. He acknowledged that he had the opportunity to examine the notes for ITS operations available at that location. He also said he had visited one or more of the contracted carriers' headquarters. Additionally, almost all of the Committee staff's written inquiries about ITS operations and replies from the FRBB were sent to Donald J. Winn, assistant to the Board of Governors and Congressional liaison who directly serves Chairman Alan Greenspan. There are a number of other officials at the Board of Governors in the Division of Reserve Bank Operations and Payment Systems who have supervisory roles over the Fed's check clearing operations.

Complaints of Intimidation: Fed staff who sent numerous signed statements about ITS management in response to the Committee's inquiries, with copies to the FRBB Executive Vice President and General Counsel William N. McDonough, complained that they were intimidated for what they believe to be truthful replies.

On August 30, 1995, Thomas McFarland, an ITS supervisor, wrote to the Committee about a meeting he had with FRBB Vice President Richard Burns, the officer directly in charge of the ITS office. Mr. McFarland stated that at that meeting Vice President Burns spoke to him in a "hostile tone" in an attempt to influence Mr. McFarland's written replies to the Committee.[1] Charles Fazio,

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[1] Thomas McFarland described his meeting with FRBB Vice President Richard Burns: "I asked Rich if the attached draft reflected the opinions of Bob LaRocca to which he angrily responded, 'Yes.' Rich then repeated his warning to me that I should not let my personal feelings toward Bob LaRocca affect how I answered...He further stated that the positions as expressed in the draft text represented the 'Bank's position,' and that I should carefully consider the 'Bank's position' before I prepared my answers. I then asked Rich if it was his intent to influence my response. Rich answered in a controlled but hostile tone, 'Yes it is. I consider it part of my job to influence your opinion. I would be remiss in my duties if I did not point out the position that the Bank has taken, and expect that you will give full consideration to that position before you answer.' I think it is important that the Committee understands that each ITS staff member who responds to the Committee's questions with answers that differ from those in the official FRBB responses, answers at his own peril, as the FRBB is an institution that does not tolerate any dissent. The ITS staff believes that once the Committee's investigation is concluded, and the Committee has reported its findings and made its recommendations, that each ITS staff member who responds to the Committee with answers that differ from the 'Bank's

also an ITS employee, wrote to the Committee that he was also called into FRBB Vice President Richard Burns' office during the same week and handed a packet of material that Mr. Fazio understood to be the "Bank's position" that he should use in his reply to the Committee.[2] Dave MacDonald, another ITS employee, also wrote that he was very troubled by possible repercussions from replies to the Committee that he considered truthful. He said "that by honestly and accurately answering your Committee inquiries I will be forced to contradict the positions taken by the Senior Management of the FRBB."[3]

Following these complaints of intimidation sent to the Committee via his office, FRBB Executive Vice President and General Counsel William N. McDonough notified the Committee on September 14, 1995 that he "had instituted an investigation of these allegations" and he said, "I take very seriously the allegations of intimidation and possible retaliation against staff for taking positions contrary to those taken by management."[4]

<u>FRBB Vice President Richard Burns, the FRBB officer supervising ITS, sent criticisms of his staff to the Committee after they began directly answering Committee staff inquiries:</u> The ITS staff had replied to the Committee about a payment of over $550,000 by ITS to a private vendor for upgrading to another airplane. (This upgrade is discussed in Part 6E.) The ITS

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responses will find, to varying degrees, their careers adversely affected and be subjected to some form of retribution. The punishment may not be immediate, but I have no doubt it will be exacted." (August 30, 1995 letter to Committee staff, pp. 1-2.)

[2] Charles Fazio informed the Committee about his meeting with FRBB Vice President Richard Burns: "I surmised that anything I said which didn't support the `Bank's position would be interpreted as having an axe to grind with Mr. LaRocca. Mr. Burns then told me that he wanted to know if anyone other than an [FRBB] officer had anything to do with influencing my responses. I took this to mean that sharing information with other ITS staff was off-limits." (August 29, 1995 letter to the Committee staff, p.1.)

[3] Dave MacDonald stated: "I feel very uncomfortable about this situation because my answers may differ from FRBB Senior management's...Now I find myself in a position that by honestly and accurately answering your Committee's inquiries I will be forced to contradict the positions taken by the Senior Management of the FRBB and by doing so leave myself open to the possibility of retaliation by management." (August 31, 1995, p.1.)

[4] Mr. McDonough said: "One element of the staff responses which I take very seriously is the allegations of intimidation and possible retaliation against staff for taking positions contrary to those taken by management. As the General Counsel of the Bank as well as the Senior Personnel Officer, it is my responsibility to insure that intimidation and coercion do not take place. The Bank has an explicit policy against intimidation and coercion (copy attached) which is strictly enforced. In accordance with that policy, I have instituted an investigation of these allegations and want you to know that the Bank takes these matters very seriously and does not condone or permit any violations of Bank policy, particularly those relating to management/staff relationships. I will keep you posted on the results of our investigation." (Letter to Committee staff, September 14, 1995, p. 1.)

staffers had extensive experience with ITS operations and some had participated in monitoring and checking on the aircraft in question while FRBB Vice President Richard Burns had only been in charge of ITS for 18 months. Vice President Richard Burns wrote to the Committee about his problems with his staff :[5]

> **On the need to influence staff's replies to the Committee:** "I believe I talked to Chuck Fazio first, and because I was cognizant of being careful NOT to come across as intimidating, I fumbled over how to state that I did in fact want to influence their opinions to the extent that additional information should broaden the basis for an opinion."
>
> **On refuting staff's comments that they were shown "bank's position":** "To the best of my recollection, I never indicated or implied to any staff member that the enclosed documents represented the Bank's position and that it was important that all ITS employees support the Bank's position."
>
> **Permission for staff to say FRBB Vice President Richard Burns influenced them:** "With each staff member thereafter, [after Charles Fazio] I just stated that they should feel free to state in their response that I had influenced them, because I felt it my ongoing responsibility to influence their opinions with information."
>
> **On the staff's attitude:** "In various situations over my eighteen months in ITS I have had to filter out sarcasm and banter to get to an understanding of base facts, so I also felt it important to ask staff up front and very pointedly to try to form their opinions dispassionately."
>
> **On the staff's view:** "With respect to the [ITS] staff opinions about each of the specific questions posed by [Committee staff], I believe them to be somewhat narrowly focused upon the concrete and measurable facets of aircraft comparison; quite frankly, as one might expect. As in many organizations, often the responsibilities we place upon staff and the authority they are given are structured in a manner that emphasizes quantification of expected results as the preeminent basis for recommendations."

Aversion to full public accountability for ITS operations: The Committee inquiry into the Federal Reserve's payment system entered an area which one Federal Reserve official thought should not receive close public scrutiny. On April 26, 1994 Senior Vice President of Check Services of the Federal Reserve Bank of Philadelphia, Blake Prichard, told a conference of the First Vice Presidents of the Federal Reserve Banks "...the ITS operates under more public scrutiny than is fair

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[5] Memorandum from "Rich Burns" to "Bill McDonough," September 14, 1995, pp. 2 and 3, sent to the Committee under a cover letter from FRBB Executive Vice President and General Counsel William N. McDonough.

or reasonable. This scrutiny is primarily from US CHECK, the only surviving private overnight check air courier of any significance. Concerns over our management of ITS have to date stymied any consideration of pricing options that might legitimately promote expanded use of ITS by large volume check shippers..."[6]

Hiding behind the aegis of the Federal Reserve Banks' quasi-public corporate structure: The Federal Reserve often resorts to special protection from normal oversight given to government agencies by citing the quasi-public corporate organization of its 12 Federal Reserve Banks that do not use Congressionally authorized funds. Vice President Prichard of the Philadelphia Federal Reserve Bank told the conference of First Vice Presidents, "The ITS is at long last recognized for what it really is -- a private transportation utility run for the exclusive use of important overnight deliveries between Federal Reserve offices."[7]

However, the fact that the 12 Federal Reserve Banks are organized as quasi-public corporations does not spare the taxpayers from paying for Federal Reserve expenses. All funds received by the Federal Reserve that are not used for expenses or added to its surplus are returned to the U.S. Treasury and reduce the federal government's deficit. In addition, ITS is clearly part of the central bank of the United States and it is involved in interstate commerce. The FRBB and the ITS office at the FRBB are subject to supervision from the Board of Governors which is the Federal Reserve's ruling body and is an independent entity in the executive branch of the federal government.[8]

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[6] April 26, 1994 speech to the Conference of First Vice Presidents of the Federal Reserve System, "ITS COST ALLOCATION PRESENTATION,": p. 2.

[7] Bold emphasis added, April 26, 1994 speech to the Conference of First Vice Presidents of the Federal Reserve System, "ITS COST ALLOCATION PRESENTATION," p. 1.

[8] The legal standing of the ITS was specifically noted in a 1984 Federal court case: "There can be no doubt that the Federal Reserve Bank of Chicago is an `authority' of the government of the United States. As a member of the Federal Reserve System, it performs important governmental functions and exercises powers entrusted to it by the United States government...It is unquestionable that a court may review the action of either the Federal Reserve Board or its designated Banks in connection with the national check transportation system. (Flight International Group, Inc., Plaintiff, v. Federal Reserve Bank of Chicago, Defendant, Civil Action C83-2696A, February 24, 1984, Order by Judge Marvin H. Shoob, United States District Court, Northern District of Georgia, pp. 7 and 9.)

2.) Possible Violation of the Monetary Control Act of 1980

The issues involved in the violation of the Monetary Control Act of 1980 (MCA): The MCA requires the Federal Reserve to match its costs and revenues over the long run with regard to priced services.[9] The MCA also specifically requires pricing of the Federal Reserve's check clearing services.[10] The purpose of this provision of the MCA is to require the Federal Reserve to price its services without any subsidy so that private firms can compete in the market to supply these services.[11]

The Federal Reserve takes several contradictory positions with regard to its obligation under the MCA. First, the Federal Reserve states that it does not need to match its costs and revenues in each of its operations that have priced services. It can bundle these operations into larger groups and match the costs and revenues of the entire bundle of priced services. According to this contention, even if the ITS costs were greater than revenues it would not violate the MCA as long as the costs and revenues for a large group of priced services is nearly equal in that period. This statement is contrary to the orders given to the ITS personnel to produce 100 percent cost/revenue matching.

The Fed's argument against ITS cost/revenue matching: The Federal Reserve argues that it does not have to match costs and revenues for ITS services because the law permits it to group all payments and revenues into larger groups for the purpose of revenue matching. This bundling could

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[9] "(3) Over the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services priced, including interest on items credited prior to actual collection, overhead, and an allocation of imputed costs which takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm, except that the pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide." (Depository Institutions Deregulation and Monetary Control Act of 1980, Title 1, Monetary Control Act of 1980, Section 11A.)

[10] "Sec. 11A (a) Not later than the first day of the sixth month after the date of enactment of the Monetary Control Act of 1980, the Board shall publish for public comment a set of pricing principles in accordance with this section and a proposed schedule of fees based upon those principles for Federal Reserve Bank services to depository institutions, and not later than the first day of the eighteenth month after the date of enactment of the Monetary Control Act of 1980, the Board shall begin to put into effect a schedule of fees for such services which is based on those principles.

"(b) The services which shall be covered by the schedule of fees under subsection (a) are-

...

"(2) check clearing and collection services;" (Id.)

[11] Prior to 1980 check clearing services were provided at no cost to banks that were members of the Federal Reserve System.

include sorting and other check clearing services. [12] On March 23, 1995 the Federal Reserve replied to the Committee staff question of whether there had been any attempt to use fees for the electronic check presentations system to cross-subsidize paper check collection services. The Fed said that "Both electronic check products and paper check products are within the same check service category. There is no requirement that the Reserve Banks recover costs by product."[13]

The Federal Reserve's argument undermines the basis for charging competitive prices for ITS services and is disputed by the Federal Trade Commission. This bundling of different priced services for the purpose of cost/revenue matching would make it difficult to determine if charges for ITS priced services are based on costs. In 1991 the Federal Reserve was told that its bundling argument needed to be reexamined by the Federal Trade Commission's staff.

The staff of the Bureau of Economics of the Federal Trade Commission informed the Board of Governors of the Federal Reserve System on March 19, 1991 that the Fed's argument for bundling neglected that private sector suppliers do compete with specific priced services. The Federal Reserve System (FRS) "seems to conclude that because the FRS integrates sorting, transportation, and presentment activities into a single service offering, private couriers do not compete with the FRS. The FRS may wish to reexamine this interpretation. **A vertically integrated supplier [such as the FRS] does compete with firms that supply one stage of the vertical process whenever single-stage suppliers can be linked with suppliers at other stages to provide a close substitute for the integrated service."**[14]

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[12] Federal Reserve response of May 26, 1995:"As noted in Chairman Greenspan's April 28 response to Congressman Gonzalez, the Monetary Control Act (MCA) requires that, over the long run, fees for Federal Reserve services be based on all direct and indirect costs incurred in providing the services, including a private sector adjustment factor (PSAF). The Board's pricing principles reiterate this requirement and indicate that the Board intends that fees be set so that revenues for major service categories match costs. ITS costs associated with the Federal Reserve's check collection service are a <u>component</u> of total check collection costs that are recovered through the fees charged for the Reserve Banks' commercial check services. The Board of Governors reviews and approves all Federal Reserve fees and the PSAF annually at an open meeting." (P. 17.)

[13] Federal Reserve Board staff response to Congressman Henry B. Gonzalez's March 9, 1995 questions, under a cover letter from Chairman Alan Greenspan to Congressman Gonzalez, March 23, 1995, p. 9.

[14] "Comment of the Staff of the Bureau of Economics of the Federal Trade Commission Before the Board of Governors of the Federal Reserve System, March 19, 1991, pp. 14-15) "Our examination of the FRS's (Federal Reserve System's) request for comments and interviews with private couriers and banks, GAO reports, and publicly available market information suggest that private air courier services do compete with ITS. The FRS seems to conclude that because the FRS integrates sorting, transportation, and presentment activities into a single service offering, private couriers do not compete with the FRS. The FRS may wish to reexamine this interpretation. A vertically integrated supplier [such as the FRS] does compete with firms that supply one stage of the vertical process whenever single-stage suppliers can be linked with suppliers at other stages to provide a close substitute for the integrated service. Our current understanding is that customers, in fact, have such alternatives."

These statements on bundling from the Federal Reserve, however, are not consistent with instructions to the ITS personnel. ITS staff members said that it was their understanding "that it was over the long run, three to five years, that ITS was required to match annual costs and annual revenues."[15] They said their impression that there was such a target at ITS was "based on conversations with the ITS Officer and reinforced through memoranda from Senior Officers of the FRBB and other internal written documentation." That changed when the Committee staff investigation started, according to ITS staffers Hunt and McFarland: "Recently, (since this Committee's investigation) we have been told by FRBB officers, Board staff and FRBB auditors that it is not necessary that the ITS network ever match annual costs with annual revenues."[16]

There is abundant evidence that the Federal Reserve did in fact have a target of 100 percent revenue matching for ITS operations. ITS issued monthly internal memoranda reporting the cost/revenue matching of the ITS. The memoranda were sent to FRBB First Vice President Paul M. Connolly from the officer (Vice President Robert LaRocca or then Vice President Richard Burns) directly in charge of ITS. The memoranda contend that ITS matched their costs at yearly averages from 87 percent to 99 percent with an average of 93 percent for the four years 1991 to 1995. In addition, the Federal Reserve stated:[17]

> **"...the calculated long-term average cost recovery for the ITS component of the commercial check service has been approximately 100 percent..."**

In answer to Committee staff questions, FRBB Senior Vice President Robert LaRocca and FRBB Vice President Richard Burns claimed that ITS had matched costs and revenues and that the target has been 100 percent cost/revenue matching:[18]

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[15] "Responses to the Congressional Committee Inquiry of November 7, 1995, to FRBB Executive Vice President and General Counsel William N. McDonough from Thomas Hunt and Thomas McFarland, November 8, 1995, p. 1.

[16] "Responses to the Congressional Committee Inquiry of November 7, 1995, to FRBB Executive Vice President and General Counsel William N. McDonough from Thomas Hunt and Thomas McFarland, November 8, 1995, p. 1: "Response: Up until early 1995 it was Thom Hunt's understanding that ITS was required to match annual costs with annual revenues. Up until late in the year 1991 it was Tom McFarland's understanding that the ITS network match its annual costs with its annual revenues. Both of these opinions were based on conversations with the ITS Officer and reinforced through memoranda from Senior Officers of the FRBB and other internal written documentation. ...Recently, (since this Committee's investigation) we have been told by FRBB officers, Board staff and FRBB auditors that it is not necessary that the ITS network ever match annual costs with annual revenues."

[17] Bold emphasis added, Federal Reserve response, May 26, 1995, p. 19.

[18] Tape of Committee staff interview at the FRBB, March 24, 1995. (The FRBB and the Committee staff both agreed to tape the interviews and the FRBB supplied transcripts to the Committee made from their tape.)

Committee staff: "Do you attempt to match costs and revenues for your operations?"

FRBB Senior Vice President Robert LaRocca: "Actually over the years we actually have cost/revenue matched ITS. One of the problems with the way the language is read, you know, our goal is to come in at 100 percent. You know, they don't want you to come in at 105 or 106... But overall we came very close to 100 percent, plus or minus, a little bit, for years. Always. I don't know the last year or two because I haven't been involved, but--"

FRBB Vice President Richard Burns: "...to and including [19]94"

FRBB Senior Vice President Robert LaRocca: "To and including [19]94, Yeah."

However, the cost/revenue recovery data are apparently distorted because the revenue data includes ITS overcharges for U.S. Treasury checks which are discussed in Part 5. If these overcharges are removed, ITS apparently covers only about 75 percent of its costs. This suggests that ITS' services to private users are significantly underpriced, contrary to the requirements of the MCA.

ITS Cost/Revenue Matching
According to Monthly Internal Federal Reserve Reports

Date of report	Month covered by report	Recovery rate for month, *percentage*	Recovery rate year ending in designated month *percentage*
1-10-92	December 1991	89	87
1-15-93	December 1992	99	96
1-13-94	December 1993	98	96
1-06-95	December 1994	86	93
		Average percentage	93

3.) Improper Contracting Practices

A.) The Federal Reserve awards contracts without competitive bidding

Santa Express is a private company that provides loading and unloading services at the five hub cities for ITS and operates the ITS central control facility at Duxbury, Massachusetts, which coordinates and manages the nightly ITS operations. **Santa Express has been awarded all of its contracts with ITS for these operations without competitive bidding since 1987.** The Federal Reserve argues that these non-competitive awards were justified by claiming that Santa Express is a "sole source" for the services it provides to the Federal Reserve, its only customer. There is no evidence to support the claims of the Federal Reserve, and it is likely that other offerors could be found. In fact, these operations previously were obtained through competitive bids.

The current ITS contract with Santa Express, which expires in 1996, continues to include both hub-ground operations and the central control facility. The annual payment to Santa Express under this contract is **$1.976 million.**[19] In addition, the Federal Reserve has paid Santa Express a total of $1,497,100 from 1989 to 1994 for additional freight handling services.

Competitive bidding in the past: The historical record of both the central control function and the hub-ground operations of ITS shows that these two operations were awarded to private vendors by ITS on the basis of competitive bidding until 1987 and 1990, respectively, when they were separated. [20]

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[19] Approximately 85 percent of the cost to ITS for Santa Express' services are attributable to the hub-ground operations and 15 percent for the central dispatch function. The breakdown is as follows: weekday central dispatch function, $210,421.20; weekday hub-ground, $1,253,560.95; and weekend hub-ground and central dispatch function $512,017.85 for a total of $1,976,000. By applying the same percentage of cost distribution for the weekend work as is shown between the weekday hub-ground and central dispatch functions, an estimate of approximately $85,946.69 of the weekend costs can be attributed to the central dispatch function. $426,071.16 is attributed to weekend hub-ground operations. The overall weekday and weekend breakdown is $296,367.89 for the central dispatch function and $1,679,632.11 for the hub-ground. Since this is an extremely labor intensive operation, the rise in unit labor costs is used to adjust this number to mid 1994 prices. Unit labor costs rose by 9.95 percent in that period. If that percentage is added to the $1.2 million paid to Corporate Air in 1987 for hub-ground operations, the mid-1994 cost of these services would be $1.32 million. The present $1.697 million annual payment is $360,000 per year higher or $1.44 million higher for a four year contract.

[20] The hub-ground operations had been provided by Corporate Courier which was part of the then Connector Zone contractor, Corporate Air, Inc. (The Connector Zone contractor provides air services between the five hub cities and the west coast.) These hub-ground operations were supervised by Jack Davis. Corporate Air and Corporate Courier were informed in 1986 that the hub-ground operations would be separated beginning with the 1987 Connector Zone contracts. The compensation to Corporate Courier for the last year ending in mid-1987 for the the hub-ground operations was approximately $1.2 million and the central control facility cost Corporate Air approximately $125,000, according to information received by the Committee. Barry Lutin was the chief operating officer at Corporate Air Inc. Mr. Lutin's company had been a large contracted carrier with the ITS. In 1990. Mr. Lutin had asked the ITS for some

Federal Reserve Payments to Santa Express for Payments Not Covered by Contract 1989 - 1994

Year	Amount
1989	$335,000
1990	300,000
1991	363,000
1992	384,000
1993	104,000
1994	11,100
Total	**$1,497,100**

Personnel Employed at Santa Express

Location	Full-time	Part-time
Central Control, Duxbury, Massachusetts	6	2
New York	7	1
Cleveland	4	1
Atlanta	4	1
Chicago	6	1
Dallas	3	0
Total	30	6

Source: April 28, 1995 reply from the FRBB

additional funds to cover losses Corporate Air Inc. was incurring in maintaining some of its aircraft in the Blue Zone contract. The ITS gave Corporate Air, Inc. some additional funds and then held new bidding for the contract.

In 1987 Flight International was awarded the Connector Zone contract through competitive bidding and Corporate Courier Inc. was awarded the hub-ground operation without competitive bidding. Jack Davis had purchased the hub-ground operations from Corporate Air Inc. and formed his own company, Santa Express. In mid-1987 ITS negotiated a separate one-year contract with Santa Express without competitive bidding. In 1990 ITS purchased computer hardware and developed software to use in the operation of the central control function. ITS negotiated a three-year contract with Santa Express giving them a contract for both the central control facility and the hub-ground operations.

Following 1987, Santa Express received three one-year contracts for hub-ground operations without competitive bidding. In 1990 Santa Express received a three-year contract for ITS hub-ground operations without competitive bidding.. On June 14, 1990 FRBB Vice President Robert LaRocca wrote to FRBB First Vice President Paul M. Connolly that "the negotiation of a three-year contract with SANTA EXPRESS for the weekday/weekend dispatch function and hub-ground operation, has been endorsed by John Kimball [FRBB Vice President and Associate General Counsel] ..." On January 23, 1991 Santa Express was awarded again the ITS central control facility contract without competitive bidding.

B.) Extension of three ITS contracts without competitive bidding:

The FRBB officers supervising ITS in 1995 authorized one-year extensions (with an option for ITS to extend them another six months) of the contracts to three vendors. This action was taken with no competitive bidding. The FRBB reported this extension in a response to Committee staff on July 20, 1995. They said that "**As a result of the negotiations, the contracts were extended for twelve months with an option to extend for a maximum of an additional six months**" and that the payments to the vendors would increase in a " range from 5 to 11 percent..."[21]

C.) Allegations of non-competitive bidding for a contract

The Federal Reserve informed the Committee that a competitive procurement process is followed in the award of freight forwarding contracts, such as the one awarded to Sky Courier. They said that "The Boston Reserve Bank selects its primary air freight forwarding providers through a competitive procurement process."[22]

Despite this assurance the FRBB could not, in one case, find a document that is normally sent out in such a process, a Request for Proposals (RFP). In its June 20, 1995 reply, the Federal Reserve said they had been unable to locate the RFP for the 1991 ITS award of a freight handling contract to Sky Courier.[23]

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[21] The July 20, 1995 Federal Reserve response to the Committee staff July 6, 1995, inquiry stated (p. 1 and 2): "Federal Reserve Bank of Boston (FRBB) management negotiated extensions to the ITS Connector Zone contracts that were due to expire May 1995 with all three current vendors. As a result of the negotiations, the contracts were extended for twelve months with an option to extend for a maximum of an additional six months....FRBB management extended the existing contracts to allow the Federal Reserve to experiment with cost-saving modifications to the ITS network, which, if successful, would be incorporated into an RFP for competitive procurement for connector zone services to commence during 1996...FRBB management has indicated that all three Connector Zone contract extensions included payment increases based principally upon cost increases over the past four years. The increases, which range from 5 to 11 percent, were negotiated by FRBB separately with each vendor, and include the cost of complying with a 1994 manufacturer-issued service bulletin requiring the periodic replacement of engine turbine blades, among other factors. At the same time, FRBB included provisions in the contract with RTS to eliminate the services of one Lear 35, used for the West Coast routes. As a result, the annualized cost of the RTS contract, rather than increasing by 11 percent, would be reduced by 4.6 percent following implementation of that change.

"During December 1994, Richard Burns, Vice President, reached verbal agreements with the current connector zone carriers to extend the contracts beyond May 1995. The connector zone carriers and Mr. Burns finalized terms for the contract extensions during May. John Kimball, Vice President and Associate General Counsel, reviewed the contract extensions for legal sufficiency and consistency with Bank procurement problems. Paul Connolly, First Vice President, then reviewed and approved the contract extensions."

[22] Reply to Committee staff inquiry, April 28, 1995, P. 4.

[23] "The FRBB has not been able to locate in its files an RFP for the Sky Courier contract. A copy of the contract itself, however, is enclosed for your information." (P. 3.)

During a June 26, 1995 interview with Committee staff at the FRBB, Senior Vice President Robert LaRocca was asked if Sky Courier was awarded a contract without competitive bidding. He said: "**They did not receive it without competitive bidding. I can't recall whether there was a formal RFP....** We went around and got rates from people and Sky was just the most competitive."[24]

The ITS staff who direct operations at the ITS did not have such memory lapses. They claimed that a bogus bid was sent to the Committee by the FRBB officers supervising ITS in order to make it appear that competitive bidding occurred. They stated: "**We are quite certain that this procurement was not a competitive procurement...** Furthermore, we believe that the bid that was submitted by SANTA Express [a copy of which was sent to the Committee] was requested by Bob LaRocca for the `Files' and only for the ITS `Files.' **Requesting that SANTA submit a bid for this air freight forwarding work was a deception**, as it was well known within the ITS Office that SANTA could not effectively compete for air freight forwarding work due to business constraints that had to be borne by SANTA as a cession to receiving a no-bid FRBB contract."[25]

The ITS staffers state that "at least a half dozen letters with accompanying brochures for air freight forwarding companies asking for an opportunity to meet with Bob LaRocca " were received at ITS. The staff contend that "These companies were always rebuffed."[26]

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[24] Bold emphasis added, transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 4, p.21.

[25] The ITS staff further stated that the Committee had been sent a bogus proposal for the Sky Courier contract to make it appear there had been competitive bidding and that other factors entered into the contract award. (Memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, "Responses to the Congressional Committee Inquiry of October 3, 1995," October 11, 1995, p. 6) "We are of the opinion that this contract was given to Sky Courier because of the common backgrounds shared by Bob LaRocca and the Sky Courier sales representative. Furthermore, we believe that the bid that was submitted by SANTA Express was requested by Bob LaRocca for the `Files', and only for the ITS `Files.'"

[26] "Response to October 6, 1995 memos of Bob LaRocca and Rich Burns," to Committee Staff from Charles Fazio, Dave MacDonald, Thomas McFarland, and Mike Reveliotty, November 13, 1995, p. 2: "Shortly thereafter, despite the fact that there were at least a half dozen other air freight forwarding companies that were seeking to bid on ITS work, a contract for the ITS weekday air freight forwarding was negotiated between Bob LaRocca and the Sky Courier salesman."

4.) "Gifts" to Nonperforming Contractors

A.) $1.5 Million for a missing backup aircraft

The FRBB negotiated two agreements not covered in the original contract awards to pay a private vendor for an airplane that the Committee investigation found was missing much of the time. The private vendor was Executive Jet Management, Inc. (EJ), also known by the name of an affiliated corporate entity, RTS Capital Services, Inc. (RTS).[27] The total payments from 1991 to 1994 for this missing aircraft was $1.543 million. The agreements called for *a warm standby* spare aircraft to be stationed at Teterboro Airport. The phrase "warm standby" is a term widely understood in the aircraft industry to designate a plane ready to fly with a crew.

Fed staff stated that the officials of RTS were "well aware of the requirements within the RFP to provide backup Lear jet aircraft to cover for any scheduled or unscheduled maintenance events."[28]

Payments for the warm standby aircraft continued even though the ITS personnel told the Committee that they knew at that time that RTS had not been providing a warm standby backup as specified in a April 23, 1991 letter of agreement. Nevertheless, RTS evidently wanted more money, which was provided by a 1992 contract amendment: "FRBB agrees to pay ITS the annual amount of $208,236, plus F.E.T. which, when combined with item No. 2 of the April 23, 1991 amendment, will cover the full fixed costs of the eighth Lear 35A." The letter stated that "RTS agrees to continue to maintain a 'warm standby' Lear 35A to accommodate ITS network needs..."

The dates and amounts of payments by ITS for the warm standby plane authorized by the two contract amendments are listed in a table on page 21. **Since the original arrangement was made to provide extra money to one vendor before competitive bidding for the contract ended, the Federal Reserve officials clearly circumvented the bidding process.**

Falsifying a contractual agreement, the change in routes deception: The reason given for doubling the payment - an increase of over $624,000- for the spare plane in the April 23, 1995 contract amendment was stated to be "**in consideration of the network changing from seven**

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[27] RTS Capital Services Inc. was a subsidiary of Executive Jet Aviation, created to conduct business with ITS. RTS Courier was a wholly-owned subsidiary of RTS Capital Services.

[28] Memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, entitled; "Responses to [staff] Inquiries of September 5, 1995," from Thomas McFarland, September 21, 1995, p. 3: "...Both Jim Christiansen [president of RTS] and Al Pod [vice president of RTS] offered assurances that RTS management was well aware of the requirements within the RFP to provide backup Lear jet aircraft to cover for any scheduled or unscheduled maintenance events. Al Pod said that RTS had, in fact, already been in contact with a number of air cargo charter companies that were receptive to chartering Lear jets to RTS on an on-call basis."

routes to eight. **The number of flight hours will not change."**[29]

However, according to statements by ITS staff and documents the Committee received, there *was no change in the number of aircraft routes* between the time the contract was awarded to RTS in 1991 after supposedly competitive bidding and the two letters of agreement in 1991 and 1992. There was also *no change in any of the routes flown by RTS after the letters of agreement.* The absence of any change in routes is verified by four ITS staff (Thomas McFarland, Mike Reveliotty, Dave MacDonald, and Charles Fazio) who monitor and plan ITS routes. They all signed a written statement specifying that:"**the only reason for this contract amendment was to give more money to RTS.**"[30]

The missing warm standby aircraft at Teterboro: The RTS (also called "EJ") warm standby jet required in the agreement was missing from Teterboro Airport nearly all the time in 1992 before the Fed authorized a doubling of annual payments for this aircraft, from more than $624,000 to $1.248 million (plus tax).

Entries noting the missing spare are described in the "operational notes" at the Santa Express headquarters in Duxbury, Massachusetts. ITS awarded Santa Express, whose only customer is the Federal Reserve, a series of contracts that included the operation of the *central control facility* that monitors and directs nightly ITS operations, as described in Part 3A.[31]

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[29] Bold emphasis added, letter from then FRBB Vice President Robert LaRocca to Albert Pod, Vice President, Executive Jet Management, Inc., June 10, 1992.

[30] Memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, entitled; "Responses to Committee's inquiry of September 5, 1995," from Thomas McFarland, Mike Reveliotty, Dave MacDonald, and Charles Fazio, Sept. 21, 1995, p. 1): Committee staff question 2: "Please have [staff]...state whether they believe there was an increase from 7 to 8 routes in the RTS contracted service after the initial contract was awarded to RTS and the June 10, 1992 agreement which stated that the 'FRBB agrees to pay RTS the annual amount of $208,236, plus F.E.T. which, when combined with No. 2 of the April 23, 1991 amendment will cover the full fixed costs of the eighth Lear 35A. This is done in consideration of the network changing from seven routes to eight.' If the underlined statement is incorrect, explain, to the best of your knowledge, why ITS entered into an agreement to award RTS an additional annual amount of $208,236 for a 'warm standby Lear.'"

"Responses [of ITS staff]: There was never any change in the number of routes flown by RTS from the commencement of the contract through the June 10, 1992 contract amendment. We believe that the reasons stated in this contract amendment for the increased payments to RTS are not valid, and that the only reason for this contract amendment was to give more money to RTS."

The FRBB officers supervising ITS argued that the eighth route was similar to that of a previous contracted carrier flying these routes, Flight International. This reply was irrelevant and misleading because there was no change in the number of routes since the 1991 ITS contract award to EJ which did not provide for eight routes or payment for a plane in maintenance.

[31] The ITS has also called the central control facility the "chief dispatching operations" (November 2, 1989 memorandum from FRBB Vice President Robert LaRocca, with subject: "Recommendations for ITS Chief Dispatch [and] Management Information System (MIS)," p. 1) and the "Central Dispatch Function (CDF)".

<u>A misleading survey on the missing spare from the Board of Governors</u>: After the Board of Governors sent a misleading reply to the Committee that the spare plane had been at Teterboro 72 percent of the time between 1992 and 1994, Committee staff requested a more accurate report. The incidence of the failures of the spare to appear at Teterboro Airport during the first half of 1992 when the Federal Reserve doubled the payments for the spare was especially significant. The Federal Reserve replied that **"Data for months prior to November 1992 were incomplete and, therefore, were not included in the sample."**[32]

The 72 percent survey statistic from the Board of Governors was misleading according to the ITS' operational notes of its central control facility operated by Santa Express. (The entries in the operational notes are included in the table on page 22.[33])

The ITS staff recorded information from the ITS' operational notes on the availability of the warm standby spare for 1992 through September 1995. They could find only one entry, April 16/17, 1992 before May 7/8, 1992 in which a spare was recorded as being at Teterboro Airport. From January 1992 to September 1995 the spare was recorded as present 58.1 percent of the time. The ITS staff were unable to ascertain from the records the status of the spare 2.8 percent of the time.

<u>Federal Reserve officials defend the payment for the missing plane by arguing that a plane in maintenance could be considered the "*warm standby Lear 35 jet to be based at Teterboro Airport during the week*:</u>" Federal Reserve officials argued that even if the spare plane were not at Teterboro at the beginning of the evening, even if Santa Express' central control facility recorded, "EJ no spare," the spare was present. In fact, they argued that it was always present. During the June 26, 1995 Committee staff interviews at the FRBB, Vice President Richard Burns, who was directly in charge of ITS, stated: "**The spare was always in the network.**"[34]

FRBB Senior Vice President LaRocca explained during the June 24, 1995 Committee staff

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[32] Responses under Donald Winn's (Assistant to the Board of Governors) cover letter to Committee staff, June 20, 1995, p. 2: Committee staff: "Please supply the documentation and the methodology for obtaining a 72 percent on station calculation for the warm standby Lear 35A called for in the RTS contract, as specified in the addendum to Don Winn's June 7, 1995 reply. Was the warm standby always a Lear 35A as called for in the agreement with the FRBB? If not, please elaborate giving exact dates."

Federal Reserve Response: "...For selected months Board staff noted whether or not a backup airplane was identified on both RTS's and ITS' logs as available at the beginning of each night... The months selected began with November 1992, included January, July, and November for the years 1993 and 1994, and January through May 1995. Data for months prior to November 1992 were incomplete and, therefore, were not included in the sample.

[33] On a few dates the ITS' operational notes contained uncertain information about the EJ spare. This problem occurred before and after November 1992.

[34] Bold emphasis added, transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 2, p.5.

interviews at the FRBB that a plane in maintenance could be the spare aircraft: "The difference was with RTS [also known as EJ] **if they wanted to use that plane in maintenance, the eighth plane[,] leave it in maintenance all [the] time [,] that was fine** as long as they do their 95% [a measure of on-time performance]"[35]

Thus, the Federal Reserve officials were contending that a plane incapable of flying and housed in a maintenance facility could be considered the **"Warm standby Lear 35 to be based at Teterboro Airport during the week" as specified in the contract they authorized.**

FRBB Senior Vice President LaRocca stated that a "warm standby" meant a plane and pilot crew without any stipulation as to where such a crew and aircraft would be stationed. This statement contradicts his explanation since **a plane in maintenance does not have a crew.**[36]

<u>FRBB officer admits that doubling the payment to RTS was made to help the vendor financially</u>: In his October 6, 1995 response, FRBB Senior Vice President LaRocca admitted it was his decision to double the payment to RTS in the contract agreement amendment of June 10, 1992 because the company was incurring chartering costs: "A review of the first year of 50/50 cost sharing showed that **RTS had lost more than $300 thousand** between the excess chartering costs and the unbudgeted cost for the eighth Lear 35...I made the decision that it was in the best interest of the ITS to fund the other half of the eighth Lear 35 for the remaining term of the contract."[37]

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[35] Bold emphasis added, transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 2, p.14.

[36] FRBB Senior Vice President Robert LaRocca memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, October 6, 1995, "Responses to [Committee staff] Fax of September 5, 1995,": "As I have stated 'warm standby' meant a plane and pilot crew. If it were literally true that every night a Lear 35 had to be sitting at Teterboro Airport the cost to RTS would have been prohibitive. In other words, they never could have agreed to that arrangement, because they would have had to charter every time they had a mechanical problem or maintenance need." (p. 1.)

[37] FRBB Senior Vice President Robert LaRocca memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, October 6, 1995, "Responses to [Committee staff] Fax of September 5, 1995," p. 2.

$1.543 Million from ITS for "Warm Standby Spare Plane" to be Furnished by Executive Jet Management, Inc. or its Affiliated Company, RTS Courier

Date of Invoice/Date of Payment	Contract Date	Amount (including tax)
Invoice not dated/general ledger date of payment, 5-31-1991	Per April 23, 1991 memo	$136,154.24
Invoice not dated nor specifically described/ general ledger date of payment, 11-22-1991 labeled as "standby aircraft"	Per April 23, 1991 memo	221,250.75
6-10-92/6-12-92	Per April 23, 1991 memo	221,250.75
10-16-92/11-6-92	Per April 23, 1991 memo	221,250.75
10-16-92/10/22/92	Per April 23, 1991 memo	221,250.75
10-13-93/10-22-93	As per June 10, 1992	221,250.75
10-13-93/10-22-93	As per June 10, 1992	221,250.75
11-1-94/11-4-94	As per June 10, 1992	74,736.76
11-1-94/11-10-94	FET for 11-1-94 payment	4,671.04
TOTAL		1,543,066.54

RTS Spare Occurrences Recorded by ITS Staff in October 1995*

Date	Number of days	Spare	No spare	No record	Percent spare	Percent no spare	Percent no record
1992	200	66	116	18	33	58	9
1993	200	123	76	1	61.5	38	0.5
1994	199	147	50	2	73.9	25.1	1
1995	150	100	50	0	66.7	33.3	0
Total	749	436	292	21	58.1	39.1	2.8

*ITS staff who recorded this information in October 1995 may not have had complete access to 1992 Santa Express records that Committee staff viewed on March 24, 1995. The 1992 record is included in the table and indicates more "no spare" entries than in this table. Two examples are: (1.) The record was based on an entry for March 12, 1992 classified as "no record." The entry in the Santa log for that date was "E.J. NO SPARE ... E.J. 671-3 MECH. IN DENV (LEFT ENGINE WOULD NOT START)" (2.) The record was based on an entry for June 2, 1994 classified as spare at Teterboro Airport. The June 2, 1992 log stated "EJ has a spare but cannot fly through T-storm due to Radar problem."

Dates During 1992 that "No Spare" Was Recorded by ITS at the Central Control Facility

Month	Dates
January	4-5, 7, 8, 13, 15, 16 ("EJ 176-1 BROKE IN NEWY, A/C DOWN ALL NIGHT. THEY STILL HAVE THE LR-23 CHARTER FLYING OUT OF RICH."), 21-22, 23, 27, 28, 29 ("EJ CHARTER CASI'S CHIC BASED MU2 WAS FIXED IN TIME TO FLY 474-1. EJ LEAR WAS FIXED IN TIME TO FLY 474-1 AND CASI WENT BACK TO CHIC EMPTY")
February	3, 4, 10, 11, 12, 13, 18 ("E.J. 474 Broke - Chartered L.R. 24 from, A.F.S. Tail # 157 AG ... EJ chartered 2nd :L.R.24 from Flt. Ops. To Assist on 474-4 due to wt./Bulk. Tail #57 F.L."), 19, 20, 24, 25, 26
March	2, 3, 4, 5, 9, 12 ("E.J. NO SPARE ... E.J. 671-3 MECH. IN DENV (LEFT ENGINE WOULD NOT START)"), 17, 18, 19, 30 ("E.J. Chartered a Lear 24 from American Air..."), 31
April	2, 6, 7, 8, 9, 13, 14, 20, 21, 22, 23, 27, 28, 29, 30,
May	4, 5, 6, 12 ("NO SPARE AFTER 2400), 13, 14, 26 (" E.J. HAD A SPARE UP UNTIL 0030"), 28 ("E.J. HAS A SPARE UP UNTIL 474.4 departs TEB. Spare crew is based in MINN & flying back on 474.")
June	2 ("E.J. HAS A SPARE BUT CANNOT FLY THROUGH T-STORM DUE TO RADAR PROBLEM."),3 ("EJ's Spare broke"), 16, 25
July	8, 14 ("WERE GOING TO USE THEIR SPARE BUT IT BROKE AS WELL."), 15, 16, 21, 22, 29
August	3, 4, 6, 10, 11, 12, 13, 17, 18, 19, 20, 24, 25, 27, 31
September	[Entry on September 1, "E.J. had a spare!!!"] 8, 10, 14 {"E.J. No Spare... approx for 2 weeks (maint)...E.J. FLT 643-1 Broke in SALT HAD NAT's COURIER DELIVER THE SALT & LOSA 2ND DISPATCH TO THE DENV FED TO BE PUT ON 671-3 TUESDAY....E.J. couldn't get a charter to cover 643-3, therefore, HAD BANK AIR FLT 373 once it got to CLEV, turn AND GO BACK TO CHIC TO PICK-UP YELLOW THAT WAS TO BE PUT ON 643-3,...E.J. USED THEIR 323 A/C TO DEADHEAD TO ATLA TO PICK UP ROUTE 643-4"}, 16, 17, 21, 22, 23, 24, 28, 29, 30
October	8, 14, 21
November	3 ("E.J. Spare in TEB down due to ... problem."), 9, 10, 12, 15, 16
December	1, 7, 8, 9, 10, 14, 15 ("E.J. HAD A SPARE UNTIL 0300, THEN SWAPPED W/ 474 A/C due to mechanical."), 17 ("E.J. HAD A SPARE AT 0200 (IN TEB)"), 21, 28

<u>When the warm standby spare was regularly on station</u>: When Federal Reserve Vice President Richard Burns was promoted and became the officer directly in charge of ITS in late 1993, he directed EJ to provide a warm standby Lear. This effort included chartering aircraft to serve as a standby spare when an EJ Lear 35A was undergoing a 12,000- hour required maintenance service. He explained his actions by saying that the contract amendment requiring a warm standby spare only

applied to periods when a plane was in long-term maintenance.[38] RTS (which is affiliated with Executive Jet) had the next to lowest performance record for all of 1992.This on-time performance record was reported in official ITS records circulated to the FRBB officers supervising ITS.

1992 Carrier Performance Rates (percentage on time) at ITS Inspections

Carrier	All of 1992
RTS Courier, Inc (Connector A/B)	96.4
CASI (Connector D)	98.5
Epps Aviation (Blue Zone)	96.6
Top Flight (Red)	96.7
Bankair (Yellow)	97.7
Bankair (Connector C)	98.2
CASI (Green)	98.3
CASI (Brown)	97.5
ACT (Hele, Seat, & Port)	96.1

The meaning of a Federal Reserve contract is reserved for those privy to its "intent and interpretation:" In response to a Committee inquiry, the Fed sent a November 1, 1995 cover letter from William N. McDonough, Executive Vice President and General Counsel of the FRBB which contained a statement from FRBB Vice President and Associate General Counsel, John Kimball. Associate General Counsel Kimball presented a reason for the failure to satisfy the contract amendment that specified a "*warm standby Lear 35 jet to be based at Teterboro Airport during the week.*" Associate General Counsel Kimball claimed that "**the only persons with any knowledge of the intent and interpretation of the amendment**" could interpret what it means. He added more reasons for the authorization of $1.543 million for a spare aircraft that was not regularly at Teterboro Airport and was almost never there during the first half of 1992 when the FRBB doubled the payment for it. According to this officer of the FRBB, reasons that no spare was available at Teterboro Airport are: a "**lack of need for a backup**" and, opening the list of reasons to many

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[38] According to the June 20, 1995 reply from the Federal Reserve, the chartered planes: "were Aircraft Corporation IA 1124's, jets comparable in speed and capacity to a Lear 235A. The dates of the Charters were: January 24, 1994 to February 22, 1994; February 22, 1994 to March 29, 1994; and April 27, 1994 to June 13, 1994." (p. 3).

In his October 6, 1995 reply, FRBB Vice President Richard Burns said:"Tom [Thomas McFarland] conveyed to me the impression that I had better do something, because the contract called for a spare aircraft, while not having the spare available on any night might be OK, not having one available for such an extended period [for long term maintenance] could really jeopardize the network... I advised Al Pod [at RTS] that my reading of the contract was that we should have access to a spare aircraft, and that if one other of their aircraft was going to be continuously out of service for such a long period, then I thought it incumbent upon RTS to make alternative arrangements to meet this responsibility..." (Bold emphasis added, FRBB Vice President Richard Burns memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, October 6, 1995, "Response to [Committee staff] 9/5/95 Inquiry," p. 1.)

possibilities, "etc.":[39] At a minimum, there is confusion within the Fed regarding the contractor's obligation to provide spare aircraft.

B.) $425,000 for a missing backup aircraft

In 1990, ITS awarded a contract for its Blue Zone to Corporate Air, Inc. for $2,056,000. Subsequently, Corporate Air, Inc. determined it was unable to perform the requirements of the contract at the bid price. Corporate Air, Inc. requested an additional $100,000 per year to maintain its Blue Zone operations. ITS responded by giving Corporate Air, Inc. additional funds in order to allow ITS to solicit additional contracts.[40]

In subsequent bidding for the ITS contract award, the previous Blue Zone carrier, Epps Aviation, won the ITS contract at an annual cost of $2,650,000. This payment was more than Corporate Air, Inc.'s contract including the additional payments, according to information received by the Committee. **The month after the award to Epps Aviation, ITS gave Epps an additional lump-sum payment of $400,000 plus $25,000 for tax for a backup aircraft.** This contract award was similar to an award given to Epps in a previous contract before Corporate Air, Inc. was awarded the contract for this zone. That award for a backup aircraft was never conveyed to Corporate Air, Inc. On December 23, 1988 the ITS awarded Epps an additional lump-sum payment of $223,000 to upgrade that backup aircraft (from an MU-2J to a MU-2B-60).

The phantom spare: Information received by the Committee indicates that the backup aircraft for which ITS paid $425,000 in 1991 was not regularly at Teterboro Airport except for approximately two months during the winter months of 1994.[41] A September 22, 1993 ITS on-

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[39] Memorandum to William N. McDonough, Executive Vice President and General Counsel of the FRBB to FRBB Vice President and Associate General Counsel John Kimball, October 24, 1995 under cover letter of November 1, 1995:"'[from Committee staff question] 1.... explain whether an aircraft in maintenance and not performing as a backup aircraft, under contract requiring a 'warm standby spare' aircraft, would be of any benefit to ITS if weather or mechanical problems occurred, Specifically explain how this situation is related to the repeatedly stated goal of FRBB to minimize float.'"
"[response] The interpretations of the April 23, 1991 amendment to the RTS contract that has been expressed by ITS and RTS management is a reasonable and valid interpretation of this amendment by the only persons with any knowledge of the intent and interpretation of the amendment. The amendment benefited ITS in providing a backup plane even if the backup plane was not used on occasion for any of a variety of reasons, such as lack of need for the backup, maintenance of the backup, need for the backup in places not readily accessible to the backup, prior use of the backup as replacement for other RTS planes on ITS routes, etc."

[40] ITS paid Corporate Air $3,538.46 per week from the end of March 1991 to mid- January 1992, according to information supplied to the Committee.

[41] The spare was present much of the time or a plane was chartered for the months beginning August in 1995 until October 1995. This was a period in which the Committee staff inquiry began to receive replies from ITS staff who direct operations at the ITS via the office of FRBB Executive Vice President and General Counsel William N. McDonough about ITS operations. The statements made by the FRBB officers supervising ITS about a plane in

site staff report stated: "Epps Aviation was short two aircraft, and the other was the phantom spare that no one has seen in Teterboro in '93."

When asked about the missing spare, FRBB Senior Vice President LaRocca said: "Could have been in maintenance if it wasn't there. It was working for ITS whether it was in maintenance or whether it was in Teterboro."[42]

Circumventing the Bidding Process: The bidding system was circumvented with these lump-sum payments awarded after bidding was closed. Corporate Air Inc. was not treated on a level playing field with other carriers.

Normally, the ITS requests bids. On February 1, 1991, Vice President and Associate General Counsel of the FRBB, John Kimball, asked a private law firm to review a report that contained the recommendations of the winning bidders for the ITS zones (geographical areas defined by ITS for contracted air service). The report outlines the procedures followed in the bidding process: "Requests for Proposals (RFP's) were mailed to more than fifty companies in late August of which nine responded by the November 2, 1991 deadline. No late proposals were received. The site inspection team consisted of Bob LaRocca, Vice President, ITS Office, and Tom McFarland, Operation Section Head, ITS Office. ...The lowest four proposals in each zone were analyzed in detail to determine compliance with the requirements of the RFP. Visits were made to the finalists for each zone to determine their understanding of the RFP's requirements."

Thus, the farce of soliciting proposals with full and detailed information for ITS contract awards was outwardly impressive. The additional payments described previously circumvented the bidding process and provided some bidders with more information than others.

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maintenance being a spare and other questionable statements about the spare were refuted by these staff members. Someone may have notified the vendor that a spare should be supplied during this period.

[42] Transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 1, p. 14.

Recommendations of ITS for Award of Contracts to Air Carriers for the Four Connector Zones, February 1, 1991

Zone A*		Annual dollar payment
Lowest Proposers:	1. Janair, Inc.***	3,247,375
	2. RTS Courier	4,168,394
	3. Corporate Air, Inc.	4,564,469
	4. Flight International, Inc.	4,836,774
Zone B**		
Lowest Proposers:	1. Janair, Inc.***	2,265,958
	2. Corporate Aviation Services, Inc.	2,768,767
	3. RTS Courier	2,811,408
	4. Corporate Air, Inc.	2,915,954
A+B Combination		
Lowest Proposers:	1. Janair, Inc.***	5,513,333
	2. RTS Courier	6,783,352
	3. Corporate Air, Inc.	7,145,008
	4. Epps Air Services, Inc.	8,138,090
A+B Combination Recommendation: RTS		

*The largest of the four connector zones, this zone requires four satellite jets based in New York (Teterboro), Richmond, Minneapolis and Los Angeles. ** A three-jet zone with two jets based in Miami and one in Salt Lake City. ***Janair subsequently withdrew their proposal. Source:"ITS CONNECTOR ZONE RECOMMENDATIONS FOR THE MAY 1991 TO MAY 1995 CONTRACT PERIOD," February 1, 1991)

C.) Payments for services of grounded aircraft

Contract award to North Coast Aviation (NCA) in 1990: Requests for proposals were sent by ITS to over 100 companies in late August and ten responded by November 1, 1989. FRBB Vice President and Associate General Counsel John Kimball sent copies of the recommendations to an outside law firm contracted by the Federal Reserve. North Coast Aviation, Inc. was described as having submitted the third highest bid and was recommended for the contract award for the Red Zone. The two lowest bidders were eliminated because of other factors. The memorandum contained praise for the track record of NCA as an ITS operator but it also included guarded comments about its financial statement.[43] The recommendation indicated that even if the two lowest bidders made certain changes in their equipment, past experience with ITS was given more importance.[44] Thus, the FRBB officers supervising ITS stated they placed substantial weight on a

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[43] Undated, attached to a January 29, 1990 cover note sent to the Committee: "ITS Color Zone Recommendations for the May 1990 to May 1994 Contract Period." p. 4) "NCA is a small company based at Hopkins Airport in Cleveland... NCA performed the ITS RED zone from March 1984, to December 1986 under the name, 'Sundorph," and did an excellent job... Although the [balance sheet] statement is not strong, it is much stronger than it was in 1985 and 1986 when the company was book insolvent."

[44] Undated, attached to a January 29, 1990 cover note, "ITS Color Zone Recommendations for the May 1990 to May 1994 Contract Period." p. 6: "The RFP clearly states that price may be outweighed by other factors described in the RFP in the sole judgement of FRBB. One of those factors is past experience on a contract for a Federal Reserve

vendor's past experience with ITS in deciding contract awards.

Grounding of North Coast Aviation by the FAA: On July 17, 1990 the Federal Aviation Administration (FAA) revoked the FAA Part 135 certificate of North Coast Aviation, Inc. (NCA) for alleged safety violations including **"knowingly and intentionally" falsifying aircraft identification numbers to avoid mandatory maintenance.** The FAA Part 135 Air Carrier Operating Certificate is required by the ITS for their contracted private air carriers. This FAA order was sent to the Federal Reserve and stamped "received."

The charges that NCA officials fraudulently entered identification numbers should have raised concerns about the company.

The FRBB officers supervising ITS authorized double payments for services contracted to NCA when NCA was grounded. On each route both NCA and a substitute air carrier were paid. After the final revocation order, ITS paid NCA for services clearly not rendered.

Spurious invoices: Four invoices were paid by ITS for four weeks' service by NCA following this final revocation order when no service could have been performed. It is clear from the dates of alleged NCA services after September 24, 1990 on these invoices that no service was provided by NCA on these dates. It was certainly improper to pay for these invoices and ITS personnel knew this.[45]

ITS payments to NCA "could be an exception to our procurement guidelines": On August 6, 1990 FRBB Senior Vice President LaRocca informed officials at the Federal Reserve of the dire financial condition of NCA and suggested negotiating charters with substitute carriers even though that would be "an exception to our procurement guidelines." FRBB Vice President LaRocca in effect was suggesting double payments for the services provided even though "It may not be realistic to assume we can get our money back..."[46]

Bank."

[45] Memorandum from Dave MacDonald to Banking Committee staff via the office of FRBB Executive Vice President and General Counsel William N. McDonough, "Response to [Committee staff's] September 5th inquiry," September 22, 1995, p. 1.

[46] Memorandum from Bob LaRocca to Bill Stone, Fred Herr, Ollie Ireland, Gayle Brett with copies to R. Eisenmenger, P. Connolly, and J. Kimball, August 6, 1990, pp 1 and 2: "As we discussed, NCA is in a financial bind because of the chartering cost it has incurred to keep the zone operating. I have paid $20 thousand to TAS, Inc., the former Red Zone carrier, for its costs to operate several routes for NCA. In addition, I expect to pay approximately $20 thousand to keep the zone operating through this week. We reserve the option of offsetting this $40 thousand against our weekly payment (approximately $18 thousand) to NCA. NCA has already incurred substantial financial harm because of their effort to keep the Red Zone operating. It may not be realistic to assume we can get our money back, particularly in the near term."

On September 6, 1990 LaRocca informed NCA that ITS had paid $87,331.45 in chartering costs during the period in which NCA had its Part 135 Certificate suspended. He informed NCA that these funds would be deducted from NCA's weekly payments from ITS at the rate of $900 a week for 96 weeks and a final payment of $931.35. The Federal Reserve informed the Committee that the total cost for twelve substitute carriers for NCA was $155,645, as shown in the following table.

Payments to Substitute Carriers Following the Initial FAA July 17, 1990 Grounding Order While ITS Continued Payments to NCA

Ace Air Cargo, Inc., Cleveland, OH	$10,783.00
Baron Enterprises, Marion, OH	17,139.00
Beaver Aviation Service, Beaver Falls, PA	7,142.00
Castle Aviation, Inc., Ravanna, OH	6,446.00
Contemporary Aviation, Washington, WV	1,113.00
Gordon Air, North Canton, OH	1,321.00
Prior Aviation Service, Buffalo, NY	8,226.00
Rohrer Aviation Service, Wodsworth, OH	10,462.00
TAS Aviation of Defiance, Defiance, OH	56,617.00
Tiffin Aire, Inc., Tiffin, Oh	10,084.00
Sunbird Air Services, Springfield, OH	16,883.00
Wings, Inc., Mercer, OH	9,429.00
Total	$155,645.00

Source: Federal Reserve response to the Committee staff, May 26, 1995, p. 22 and the correction for TAS Aviation of Defiance, Ohio from $76,646 to $56,617 in the response of July 26, 1995.

"NCA is attempting to merge with another company, but chances of a deal are slim at this time. If a doomsday scenario unfolds, i.e. NCA loses, our options are; A) negotiate four-month contracts with various carriers to keep the zone operating, and issue an RFP; and B) negotiate contracts that run to May 1994 with several known carriers. Option B provides the greatest security and the lowest cost; however, it could be an exception to our procurement guidelines. Option A would cost us about $200 thousand extra in 1990, but only about an incremental $25 thousand a year thereafter. Option B would cost us about $50 thousand extra in 1990 and a nominal sum thereafter."

"I will keep you informed and will seek your counsel before any decisions are made. Thanks for your continued support."

Payments By ITS to North Coast Aviation, Inc.
After NCA Was Grounded by the FAA

Date of invoice	Date of Payment	Number of NCA invoice	Dates of service as they appear on the North Coast Aviation invoices sent to the FRBB	Amount
9/4/90	9/24/90	11299	"9/24 thru 9/28/90"	$16,536.73
10/1/90	10/12/90	11317	"10/1 thru 10/5/90"	16,536.73
10/1/90	10/19/90	11311	"10/8 thru 10/12/90"	16,536.73
10/1/90	10/28/90	11318	"10/15 thru 10/19/90"	16,536.73
			Total	66,146.92

D.) Failure to pursue repayment

The FRBB officers supervising ITS authorized a $700,000 lump-sum payment to TLC Air, Inc. on September 20, 1988 "for the weekday ITS Connector Zone C relating to the rerouting and upgrading of Route 535 to a Lear 35 aircraft."[47] TLC went bankrupt about one year later, with one year and eight months remaining on the contract. **Officials who manage the ITS decided not to pursue collection of any part of the remaining payment due to ITS.**

[47] Letter from ITS Vice President Robert K. LaRocca, FRBB, to Roger Tannery, President, TLC Air, Inc.

5.) Federal Reserve Overcharging the U.S. Treasury

In response to Committee staff inquiries, the Federal Reserve conducted a survey in August 1995 to determine the cost per pound of transporting government and other checks by ITS. The average fee charged by the ITS to the **U.S. Treasury** was found to be **$4.964** per pound for the first quarter of 1995.[48] The average fee ITS charged **other customers** for transporting their canceled checks is **$2.957** per pound.

The ITS staff reported that the average cost of "moving a pound of work via ITS is approximately $3.23." The approximate charge for commercial checks is $3.10 per pound. The nearly $5 per pound charged the U.S. Treasury is a significant overcharge.[49]

Substantial savings to the taxpayers by shipping canceled U.S. Treasury checks outside of ITS: Canceled U.S. Treasury checks returned to the Federal Reserve are transported to a processing office in each Federal Reserve District. The U.S. Treasury requires that a certain percentage of Treasury checks be processed within four days unless the Treasury is notified of a delay. Thus, these checks do not have the same time sensitivity as other checks. Private sector checks incur float because of double entry of the check balance in the checking accounts of both the payor and the payee. If there is a delay in clearing these checks the float increases. No such float problem arises with canceled U.S. Treasury checks because the Treasury operates according to authorized budget appropriations and does not increase its expenditures because of float.

Since they are not time sensitive, canceled U.S. Treasury checks could be transported outside ITS for substantially less than the nearly $5 per pound being charged by ITS. Using air freight forwarders or ground transportation, the cost to the U.S. Treasury and the U.S. taxpayers could be reduced to between $0.25 and $1 per pound. The staff of the ITS verified this estimate.[50]

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[48] A note in the Federal Reserve response of August 16, 1995 indicates that because there are only 210 checks per pound rather than the 325 per pound calculation the ITS normally uses, the cost of U.S. Treasury checks may be slightly less, $4.867 per pound.

[49] "Responses to Question #5 of Congressional Committee Inquiry of September 5, 1995," memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, from Thomas McFarland and Thomas Hunt, September 20, 1995, p. 4.

[50] Memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, entitled; "Responses to Committee's inquiry of September 5, 1995," from Thomas McFarland, Mike Reveliotty, Dave MacDonald, and Charles Fazio, September 21, 1995, p. 1: "Response: To insure that Treasury checks would continue to move in a timely manner if they were moved outside ITS would require that each Federal Reserve District evaluate the various transport means available within their district to decide which transportation options would be most cost efficient. There are a number of transport means that would be comparable to the service provided by ITS and some that would be somewhat slower. We believe that while most districts would opt for one day service it is certain that every

Misleading and inaccurate replies about the costs charged by ITS to deliver canceled U.S. Treasury checks: The Federal Reserve claimed that "non-checks," a component of ITS freight which includes Treasury checks, were not allocated a full share of the costs in the past, "resulting in a slightly higher allocation to the commercial check service."[51] The opposite is true. Transportation of canceled Treasury checks bears a much higher cost per pound than transportation of other checks.

The survey the Federal Reserve conducted showed the nearly $5 per pound charge for U.S. Treasury checks in the first part of 1995, is 67 percent more than the ITS charged for transporting other canceled checks.

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district would find a cost effective means of transportation that would easily stay within the Treasury mandated four-day turn around time. The cost of these various means of transportation would range from twenty-five cents per pound to one dollar per pound depending on the weight shipped and the distance from the sending Federal Reserve Office (FRO) to the receiving/processing FRO."

[51] The Federal Reserve said: "The Boston Reserve Bank believes that non-check shipments were not allocated a full share of the costs in the past, resulting in a slightly higher allocation to the commercial check service." (p. 8.)

6.) Waste, Deception, and Insufficient Controls

A.) Fed misleads Committee about fuel provided for non-ITS uses

Although ITS provides fuel for its contracted carriers (at no charge), it attempts to control the use of its fuel so that none is provided for non-contracted uses. In violation of these controls, ITS provided its fuel to Top Flight Air Service which began to operate a new check transportation network that was not part of ITS. The new network serviced three major banks in Florida and immediately took business away from the carrier that previously provided that service. FRBB officers informed the Committee that they had not participated in any prior planning to provide fuel.

Even though Top Flight later paid for the fuel, the use of ITS fuel saved Top Flight approximately $1 per gallon because of the discounts ITS receives from bulk purchases. Top Flight, operating as a non-ITS carrier, received fuel from the Federal Reserve for three weeks in December 1992. Top Flight received 18,203 gallons of fuel at the reduced ITS cost.

After Top Flight started its service, the former provider complained about the fuel subsidy. ITS stopped supplying Top Flight fuel and one week after the Federal Reserve stopped supplying ITS fuel, the Top Flight network with the three banks terminated. FRBB Senior Vice President LaRocca denied the phone call from the former provider was related to the termination of the fuel arrangement.

Fed officials call violation of rules "*de minimis*" and "*peanuts*;" At the March 24, 1995 Committee staff interviews at the FRBB Vice President Richard Burns characterized the amount of fuel given to Top Flight as: "a *de minimis* amount of fuel." FRBB Senior Vice President LaRocca said: "The amount of fuel, you know, that we're talking about in the grand scheme of things, peanuts." The attitude apparent from these remarks is that disregarding ITS regulations about fuel was not important because the cost was not large compared to the total expenditures of ITS. The arrangement is probably not regarded as *de minimis* for private entrepreneurs who compete for these services.

The provision of ITS fuel to Top Flight was a case in which the FRBB officers in effect authorized the use of taxpayer resources to establish and assist a private company that would compete with ITS' main competitor, US Check. The ITS staff who direct operations at the ITS said this was the intent of the FRBB's assistance to Top Flight.[52]

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[52] Memorandum to FRBB Executive Vice President and General Counsel William N. McDonough, "Responses to the Congressional Committee Inquiry of October 3, 1995," October 11, 1995, p. 5: Committee staff: "What was the intent of the FRBB assisting Top Flight, Inc. in launching its transportation network given the fact that ITS was in effect creating its own competition?"

<u>The Fed's pretense of a last-minute decision and their denial that credit problems were involved</u>: The Federal Reserve treated the provision of ITS fuel for non-ITS uses only as a last-minute decision because Top Flight was too busy to make these arrangements. Under a cover letter from Federal Reserve Chairman Alan Greenspan to Congressman Gonzalez, the Federal Reserve noted the last-minute nature of the agreement to provide fuel:

> "**Upon start up**, Top Flight was unable to complete its arrangements at some locations for fuel requirements."[53]

The same claim of a last-minute plan to supply fuel for non-ITS uses was stated at a March 24, 1995 interview held at the FRBB.[54] FRBB Senior Vice President LaRocca continued to deny that Top Flight had credit problems that caused it to ask for ITS fuel. Senior Vice President LaRocca also said that there was *no risk* of failure to repay ITS for the fuel since Top Flight was flying the Red Zone under an ITS contract and the money could be deducted from the ITS payments to Top Flight. These statements **sidestepped the issue of why the Federal Reserve authorized the provision of ITS fuel for non-ITS purposes.**[55] Top Flight had great difficulty with future fuel

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Charles Fazio, Dave MacDonald, Thomas McFarland, and Mike Reveliotty: "The primary competitor of ITS was, and is, US Check. It was expected that this new check transportation network would take volume, that was critical to the economic viability of U.S. Check's Florida operations, off of U.S. Check's system and redirect some of that volume, via the new Top Flight check transportation network, to the ITS network."

[53] Bold emphasis added, material under cover letter from Chairman Greenspan, March 23, 1995, p. 5.

[54] Committee staff: "Here [referring to 12/9/92 letter from Top Flight], December 9, 1992 he [Jim Jackson, president of Top Flight] wrote a letter to you saying [reading part of letter] ...He said he needed --"
FRBB Senior Vice President LaRocca: "That's in December of 92"
Committee staff: "Right. And he needed fuel. Why did he need fuel? Was it because he didn't have credit to buy it at the airport?"

FRBB Senior Vice President LaRocca: "No, let me explain that one to you. He was already at that point in time he had probably been doing business with us in the Red Zone I'm going to say ball park about a year. Maybe longer. Maybe he started in the Fall of 91. He was approached. And again I don't know exactly how it all happened. There were three banks in Florida that he did a lot of business for. He used to fly checks for what's called the Florida Clearing House. He pushed checks all over Florida for them and apparently did a fine job of it. ... Jackson spent months working on designing and planning a new commercial check network..."

[55] FRBB Senior Vice President Robert LaRocca was asked again about the fuel arrangement (tape of Committee staff interview at the FRBB, March 24, 1995):Committee staff: "Why couldn't he get fuel at the airport?"
FRBB Senior Vice President LaRocca: "Well he didn't have his arrangements in place yet. With him, with all the work he was doing, the banks wanted to kick it off at this time. He probably would have to go to these places and sit down and talk to an FBO, negotiate an arrangement, OK?"
Committee staff: " ...He didn't have the credit to buy the gas?"
FRBB Senior Vice President LaRocca: "I don't know that. Because he eventually got it. He eventually got his own fuel

arrangements and its credit problems were known by some ITS personnel.

According to the March 30, 1995 material sent from the Federal Reserve, Jim A. Jackson, then president of Top Flight, wrote a letter dated December 9, 1992, expressing appreciation for the provision of ITS fuel and for the right to "tie in" with ITS routes in delivering canceled checks in the new Top Flight network:[56]

> "I would like to thank you for your willingness to help Top Flight get our new program started. The areas in the beginning we will need lift to are: Buffalo, Utica and Boston out of Teterboro, Helena, New Orleans, Birmingham, and Nashville out of Atlanta. Phase II, approximately in late January, we will need lift out of Midway."
>
> "The present locations that we would require fuel at Miami (450 gal.) Jacksonville (1150 gal.) Charlotte (570 gal.) and Atlanta (1800 gal.) per night. Allowing Top Flight to fuel and deduct the costs from our existing weekly wire will greatly enhance the success of this program."

Contrary to the statements of FRBB Senior Vice President LaRocca there is no mention in this letter about a temporary or three week arrangement. Instead, Top Flight informed the Federal Reserve about a longer arrangement. Top Flight President Jackson writes, "Phase II, approximately in late January, we will need lift out of Midway."

The December 9, 1992 letter from Jim A. Jackson to FRBB Vice President LaRocca **was a duplicate of a November 24, 1995 letter.** [57] Only the letter of December 9, 1992 was sent to the Committee by the Federal Reserve. The later letter changed the timing of the agreement to provide ITS fuel for non-ITS use to reflect their "last-minute" request story.

Two ITS staffers specifically state that FRBB Senior Vice President LaRocca requested a second letter from Jim Jackson to hide the fact of prior planning to provide Top Flight with ITS fuel.[58]

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deal. So I would say that would was a -- mitigate against what you are saying. I mean he must of been able to get the gas. He was able to do it after. It just took him a couple of weeks..."

[56] December 9, 1992 letter to FRBB Senior Vice President Robert LaRocca from Jim A. Jackson, president of Top Flight Air Service, Inc.

[57] The second letter was a duplicate except for the addition of tail numbers and some handwritten notes repeating the fuel requests.

[58] Thomas McFarland and Mike Reveliotty, letter to Committee staff, November 30, 1995, pp. 1-2. "In fact, the letter dated December 9, 1992 was sent by fax to ITS per the request of Bob LaRocca to replicate the earlier letter dated November 24, 1992. Bob requested that this duplicate letter with a new date be sent so that the Top Flight request for fuel assistance would appear to have been made proximate to the Top Flight network startup date of December 10,

__B.) Inadequate controls to monitor fuel use__

FRBB Vice President Richard Burns responded to a Committee staff inquiry in August 1995 that "ITS utilizes approximately 6.5 million gallons of fuel per year, or the equivalent of 125,000 gallons per week."[59] Fuel is provided at no charge to contracted ITS carriers to be used *only in transporting ITS freight* (primarily canceled checks).

FRBB Senior Vice President LaRocca stated at the March 24, 1995 Committee staff interviews that this provision of free fuel meant that contracted carriers would not have to assume the risk of fuel price changes when they bid on the contracts.

The Committee staff investigation found that there were insufficient accounting controls of uses of ITS fuel for unauthorized purposes. ITS contracts specifically state that contracted air carriers may only use fuel obtained from the Federal Reserve for service specified and not for "*repositioning aircraft, maintenance, air crew training, or any other purpose other than providing the service hereunder.*" Committee staff received information that many carriers routinely use fuel for repositioning their planes and for ferrying them to their maintenance bases. Also ITS fuel cannot be used by contracted carriers for unauthorized uses, such as carrying freight for private clients.

The FRBB officers supervising ITS and ITS personnel who direct operations at the ITS admitted that there are insufficient accounting controls over the use of ITS fuel provided contracted carriers.[60]

1992. In fact, to meet this request the entire letter had to be retyped. We believe this second letter clearly shows that Bob LaRocca was well aware of the possible implications of providing fuel for non-ITS purposes to a private carrier in direct competition with another private carrier, US Check."

[59] Memorandum from Rich Burns to William McDonough, August 23, 1995 sent to the Committee. This fuel is purchased at a discount price of approximately $.80 compared to the approximately $1.80 price paid for jet fuel by air carriers which do not have quantity discounts.

[60] Memorandum on "Response to [Committee staff] 8/4/95 inquiry." pp. 1 and 2: "While we review the fuel usage on each route for reasonableness, we do not actually reconcile fuel usage on a route basis because the usage can vary on any given night due to weather, air traffic, weight carried, and reroutings or changes dictated by network needs." "A fourth carrier, whose maintenance base is located in Atlanta, has a stated procedure to refuel on its own account, generally in Teterboro, the planes that are scheduled into Atlanta for maintenance. That carrier concedes that it has not monitored closely the adherence to the stated procedure, and that if and when not followed, the aircraft would be utilizing ITS fuel (220-270 gallons) to ferry planes to Atlanta. That carrier states that, on average, however, it ferries a plane to Atlanta every other week. In all cases, however, it used its own fuel to ferry planes back into ITS service, and in some instances, actually supplies more fuel than would be consumed on the return trip itself. ..."

"As noted above, one carrier regularly utilizes ITS fuel for repositioning and ferrying ITS aircraft to its base in Cincinnati, and reimburses ITS for that fuel. Another carrier has undoubtedly used ITS fuel on some occasions to ferry to Atlanta, but has not been required to make reimbursement. To some extent we believe also that carriers utilize ITS fuel to reposition or ferry aircraft when mechanical problems arise while in the performance of their ITS routes. We do

The Committee staff requested some documentation to verify that vendors were buying their own gas when not on ITS routes. This request was not fulfilled. Documentation for the purchase of fuel for unauthorized usage such as ferrying planes to maintenance bases and repositioning planes should be required and available.

Personnel at the ITS stated that "The margin of error could be up to 200 gallons per carrier per week" for non-ITS uses.[61] They stated that some ITS fuel "is and has been used for repositioning and for ferrying their aircraft to maintenance bases."

FRBB Executive Vice President and General Counsel William N. McDonough wrote to the Committee (letter dated August 24, 1995) that new procedures would be instituted.[62]

> "In the near future, we plan to use some combination of additional audit procedures, communications with carriers and clarification of contractual requirements regarding ITS fuel usage so as to improve the effectiveness of our controls."

The Zone of Operations and the Principal Maintenance Base for ITS Contracted Carriers

Carrier	Zone of Operations	Maintenance Base
RTS Courier, Inc	Connector between hubs	Cincinnati, OH
Epps Air Service, Inc.	Blue Zone: Northeast from Virginia to Maine	Atlanta, GA
Lindsay Aviation	Red Zone: Ohio; Kentucky; West Virginia; western parts of New York and Pennsylvania; and Michigan except upper peninsula	Cheektowaga, NY
Bankair	Yellow Zone: southeast from Tennessee and southern Louisiana to the Atlantic Ocean	West Columbia, S.C.
Corporate Aviation Services, Inc.	Green/Brown Zones: north central states from Lake Michigan west through Montana, Wyoming, Colorado, and northern New Mexico	Tulsa, OK

not believe that the overall level of such usage is substantive."

[61] Memorandum from Mike Reveliotty, Thomas McFarland and Dave MacDonald to Bill McDonough, August 11, 1995, sent to the Committee.

[62] Letter to Committee staff, August 24, 1995, p. 1.

C.) Budget dumping

The Federal Reserve authorized $8,345,758.28 in large lump-sum payments to private vendors between 1987 and 1994 that were not in the original contracts. Some were paid for future services. Many of these lump-sum payments were made to exhaust the budget allocated to ITS, which really amounts to the practice of *budget dumping*. **Some ITS contracted vendors reportedly phoned the ITS office near the end of the year to ask if any money was left in the budget that they might have for "upgrades" etc.** Eighty-four percent of these payments occurred in the last six months and 73 percent in the last three months of the year.

FRBB Senior Vice President LaRocca clearly ducked this budget dumping allegation by dismissing a "$300,000 or $400,000 underrun" near the end of the year as a "fairly small amount of money" that is available for lump-sum payments.[64] Additional information on budget dumping at ITS was obtained from the Federal Reserve's reply to the request to list all the years since 1986 that ITS spent less than its allocated budget and money was redistributed to the 12 districts following a Committee staff request. In only one year, since 1987 were any funds left from the ITS budget.[65]

The taxpayers must pay: The Federal Reserve has an obligation to lower its budget for any savings it achieves in providing services such as check clearing. The Monetary Control Act of 1980 requires any savings to be paid to the U.S. Treasury, clearly establishing that *taxpayers pay the costs for any excessive expenditures.*[66]

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[64] Transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 3, p. 34-35: "No, we would discuss any changes like this we were going to make with the Subcommittee on the Payments Mechanism and ... just say, look this is where we stand on the budget if it were late in the year: ...we're looking at this amount of $300,000 or $400,000 underrun. Now I can give you guys back the money or we have this change to make. Now we can make this change by a weekly increase to the guys to the carriers but we can save some dough if you want me to do it lump sum and it's pretty much your call. Things like that. And most everybody at the time of the year when you talk about $300,000 or $400,000 giving it back to 12 districts it's a fairly small amount of money to each individual district to get back...."

[65] Response from the Board of Governors, July 17, 1995, p. 4: Federal Reserve: "FRBB management has indicated that 1987 was the only year since 1986 in which ITS underran its budget such that the charges distributed to the Reserve Banks were reduced. In 1987, ITS expenses were $27,018,000--$608,000 less than the budgeted costs of $27,625,000. ..."

[66] Depository Institutions Deregulation and Monetary Control Act of 1980, Title 1, Section 226, Pricing of Services:" (d) The Board [of Governors of the Federal Reserve System] shall require reductions in the operating budgets of the Federal Reserve Banks commensurate with any actual or projected decline in the volume of services to be provided by such banks. The amount of the savings so realized shall be paid into the United States Treasury."

D.) Payment of $584,375 deemed a "wasteful" expenditure

On October 27, 1993 ITS made a lump-sum payment of $584,375 ($550,000 plus $34,375 tax) to Epps Air Service, Inc. to upgrade from an MU-2L to a Citation aircraft to fly a route to Baltimore. In their May 26, 1995 response, the Federal Reserve provided the Committee with the following reasons for this expenditure:

> Reason: To improve the speed and capacity on route 101 (Baltimore-Teterboro-Buffalo-Cleveland-Teterboro-Baltimore), the MU-2L was upgraded to a Citation. In addition, ITS management believed that one or two planes with greater speed and capacity than the turboprop would be required if ITS were to undertake a major redesign of the network, which was being considered. The cost of the Citation was $600,000."[67]

Using the approximately 199 flying days per year in the ITS operations, this upgrade costs over $1,000 extra per day.

After the Committee staff began investigating lump-sum expenditures not covered in the initial contracts, the FRBB officers supervising ITS said the expenditure was made to reduce the noise level at Teterboro Airport since the Citation was less noisy than the other planes in use. The new aircraft was less noisy than the MU-2L it replaced. However, since the upgrade only accounted for two of the 13 daily takeoffs from Teterboro Airport where noise problems were reported, the reduction in noise level was small.[68]

The staff at ITS reported to the FRBB officers supervising ITS that this Citation aircraft would use more fuel and was viewed by the pilots as a waste of money: "[Pilot at Epps] is still complaining about the Citation he is flying. He says that **with the more expensive Citation you need two pilots, it uses more fuel (I calculate 30-35 percent more fuel)...**" [69]

ITS staff member Thomas McFarland said the Citation upgrade had no benefits other than a slight noise reduction and **"was certainly made to help exhaust the budget."** He added: **"I**

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[67] The payment was made October 29, 1993. Responses to the Committee from the Board of Governors, May 26, 1995, p. 14.

[68] The Federal Reserve argued that this upgrade was needed for flexibility in developing a new network. The argument about flexibility has several major problems. First, this experiment could have been conducted for a short period by chartering the aircraft. Second, the Citation has not been manufactured for a number of years and does not appear to be a candidate for developing the ITS fleet of contracted planes. Third, an expert in this field of transporting canceled checks said that this was clearly the wrong type of aircraft to haul paper checks. It is likely that the primary rationale for this $584,375 lump-sum expenditure made on October 29, 1993 was related to budget dumping.

[69] Bold emphasis added, on-site inspection report, April 28, 1995.

believe this upgrade was a complete waste of money."[70]

Five ITS staff are unanimous in declaring the $584,375 expenditure to be "wasteful" or not needed: Charles Fazio, Thomas Hunt, Dave MacDonald, Thomas McFarland, and Mike Reveliotty, all ITS staffers, were unanimous in finding this lump-sum expenditure "wasteful" or not needed. The taxpayers bought a private company and airplane that was of little or no benefit to the Federal Reserve.

E.) $387,000 for a useless report and computer software

The Federal Reserve authorized the payment of $387,000 in 1993 to Arthur D. Little, Inc. for a study that resulted in a report and computer disks that were never used. The report is 104 pages and appears to be produced for a slide presentation. In response to Committee staff questions, FRBB Senior Vice President Robert LaRocca recalled one idea in the report about using freight forwarding that was already being discussed at ITS. He added: "But other than that I would have to sit down and re-read the report to see what was in there ... "[71]

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[70] Bold emphasis added, memorandum relating to "Responses to Congressional Committee's Inquiry of August 22, 1995" to Bill McDonough from Thomas McFarland, sent to the Committee, August 30, 1995, p. 2.

[71] Transcript supplied by the FRBB of the June 26, 1995 interview of FRBB personnel by Committee staff, tape 4, p.16: Committee staff: "This report appears to be made for a slide presentation because it is in large print with abundant gaps of blank space and with a number of pages containing only a two-word heading. Would you agree with the staff estimate ... that the prose portion of this report could be reset on less than 20 pages of normal 12 point print, [because] it's mostly blank?"
FRBB Vice President and Associate General Counsel John Kimball: "I don't think they get paid by the word."
[...]
FRBB Senior Vice President LaRocca: "...they did an analysis ... to see if there were ways that you could keep the same service level and spend less money or if you wanted to improve service could you do it without spending money or whatever and they could not find any ways and I think they drew that conclusion. One of the things that they came up with which was an idea that we were kicking around at the time was to try to come up with ways which we might be able to reduce the cost of the network without hammering us on the side of collecting checks effectively. ... [Example is presented of using freight forwarding] But other than that I would have to sit down and re-read the report to see what was in there ... "
Committee staff: "What use was made of those diskettes [from Arthur D. Little] and what was on them and how did you change your operation as a consequence?"
FRBB Senior Vice President LaRocca: "We didn't change our operation as consequence of the new schedule. Diskettes were a routing structure — I'm not even really sure what was on them, routing structure or the programs for doing routes — stuff like that -- which frankly we didn't find useful."

Lump-sum Payments Made by ITS to Contracted Carriers, 1987-1994

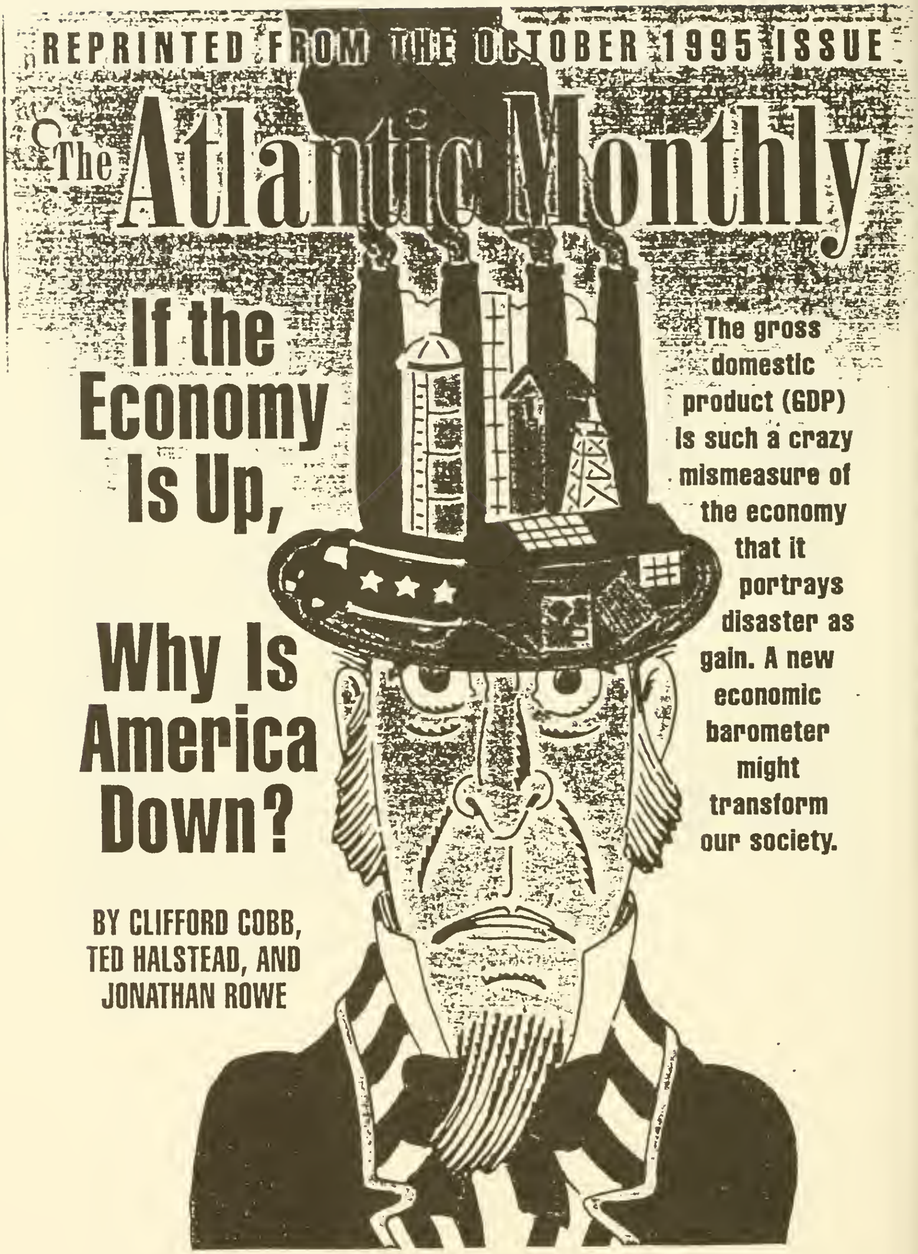
Carrier	Date	Dollar amount when in the first half of the year	Dollar amount when in the second half of the year	Dollar amount when in the final quarter of the year
Bankair, Inc	11/17/87		$517,808.33	$517,808.33
Epps Aviation	11/17/87		372,585.98	372,685.98
Epps Aviation	12/1/87		295,381.64	295,381.64
CASI, Inc	12/1/87		67,200.00	67,200.00
TAS	1/21/88	$55,250.00		
Epps Aviation	4/5/88	393,750.00		
CASI, Inc.	8/2/88		52,453.38	
Epps Aviation	8/2/88		312,900.00	
CASI, Inc.	8/16/88		83,300.00	
TLC Air, Inc.	9/27/88		735,000.00	735,000.00
Epps Aviation	12/23/88		234,150.00	234,150.00
CASI, Inc.	3/21/89	52,500.00		
Bankair, Inc	7/11/89		82,500.00	
Bankair	8/1/89		341,250.00	
CASI, Inc.	10/6/89		315,000.00	315,000.00
CASI, Inc.	9/21/90		184,800.00	184,800.00
CASI, Inc.	9/29/89		130,788.96	130,788.96
RTS Courier	5/31/91	136,993.60		
RTS Courier	11/22/91		221,250.75	221,250.75
RTS Courier	10/30/92		221,250.75	221,250.75
RTS Courier	10/22/93		221,250.75	221,250.75
CASI, Inc.	11/22/91		101,092.63	101,092.63
Bankair	9/20/91		210,375.00	210,375.00
Bankair	12/27/91		318,750.00	318,750.00
Epps Aviation	2/29/92	425,000.00		
CASI, Inc.	4/17/92	63,750.00		
RTS Courier	6/12/92	221,250.75		
RTS Courier	11/6/92		221,250.75	221,250.75
RTS Courier	10/22/93		221,250.75	221,250.75
RTS Courier	11/4/94		74,736.76	74,736.76
RTS Courier	11/20/92	-	637,500.00	637,500.00
Bankair	11/20/92		159,375.00	159,375.00
Epps Aviation	10/29/93		584,375.00	584,375.00
CASI, Inc.	11/19/93		79,687.50	79,687.50
	TOTALS	1,348,494.35	6,997,263.93	6,124,960.55
Total dollar amount of lump-sum payments is $8,345,758.28	**Percentage of total in each time period:**	**16 percent**	**84 percent**	**73 percent**

Conclusion

This report describes numerous cases of waste and abuse involving pervasive mismanagement in the operation of the Federal Reserve's fleet of contracted aircraft and auxiliary ground services of the Interdistrict Transportation System. The Federal Reserve provided insufficient justification for awarding a number of ITS contracts without competitive bidding. In some cases, the bidding process was circumvented altogether when Federal Reserve officials arranged for payments to be made to proposers before the contracts were awarded in a supposedly competitive procurement process.

The report also describes the failure of the ITS to match their revenues to their costs by a substantial margin. The Monetary Control Act of 1980 requires cost/revenue matching over the long-run for priced services. The Federal Reserve may have violated the Monetary Control Act with subsidized prices for ITS services that may have undermined actual and potential competition.

There was no evidence of meaningful, consistent internal controls by the FRBB at ITS. The lack of internal controls at the FRBB indicates that this practice is unlikely to be confined to the ITS. The result is a powerful government bureaucracy that inhibits private competition and is able to continue wasteful and abusive management practices with little to fear from the private sector. The remedies must come from the Congress which has the power to stop these practices and is obligated to provide effective oversight.



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The Atlantic Monthly

If the Economy Is Up, Why Is America Down?

The gross domestic product (GDP) is such a crazy mismeasure of the economy that it portrays disaster as gain. A new economic barometer might transform our society.

BY CLIFFORD COBB, TED HALSTEAD, AND JONATHAN ROWE

IF THE GDP IS UP, WHY IS AMERICA DOWN?

by CLIFFORD COBB, TED HALSTEAD, AND JONATHAN ROWE

Why we need new measures of progress, why we do not have them, and how they would change the social and political landscape

HROUGHOUT the tumult of the elections last year political commentators were perplexed by a stubborn fact. The economy was performing splendidly, at least according to the standard measurements. Productivity and employment were up; inflation was under control. The World Economic Forum, in Switzerland, declared that the United States had regained its position as the most competitive economy on earth, after years of Japanese dominance.

Illustrations by Seymour Chwast

The Clinton Administration waited expectantly, but the applause never came. Voters didn't *feel* better, even though economists said they should. The economy as economists define it was booming, but the individuals who compose it—or a great many of them, at least—were not. President Bill Clinton actually sent his economic advisers on the road to persuade Americans that their experience was wrong and the indicators were right.

This strange gap between what economists choose to measure and what Americans experience became the official conundrum of the campaign season. "PARADOX OF '94: GLOOMY VOTERS IN GOOD TIMES," *The New York Times* proclaimed on its front page. "BOOM FOR WHOM?" read the cover of *Time* magazine. Yet reporters never quite got to the basic question—namely, whether the official indicators are simply wrong, and are leading the nation in the wrong direction.

The problem goes much deeper than the "two-tiered" economy—prosperity at the top, decline in the middle and at the bottom—that received so much attention. It concerns the very definition of prosperity itself. In the apt language of the nineteenth-century writer John Ruskin, an economy produces "illth" as well as wealth; yet the conventional measures of well-being lump the two together. Could it be that even the upper tier was—and still is—rising on the deck of a ship that is sinking slowly into a sea of illth, and that the nation's indicators of economic progress provide barely a clue to that fact?

Ample attention was paid to the symptoms: People were working longer hours for less pay. The middle class was slipping while the rich were forging ahead. Commutes were more harried. Crime, congestion, and media violence were increasing. More families were falling apart. A *Business Week*/Harris poll in March imparted the not surprising news that more than 70 percent of the public was gloomy about the future.

Sounding much like the guidance department of a progressive New York grammar school, the Clinton Administration said that Americans were simply suffering the anxieties of adjustment to a wondrous new economy. Speaking in similar terms, Alan Greenspan, the chairman of the Federal Reserve Board, told a business gathering in San Francisco this past February that "there seemingly inexplicably remains an extraordinarily deep-rooted foreboding about the [economic] outlook" among the populace.

Those silly people. But could it be that the nation's economic experts live in a statistical Potemkin village that hides the economy Americans are actually experiencing? Isn't it time to ask some basic questions about the gauges that inform expert opinion, and the premises on which those gauges are based?

Economic indicators are the main feedback loop to national policy. They define the economic problems that the political arena seeks to address. If the nation's indicators of economic progress are obsolete, then they consign us to continually resorting to policies that cannot succeed because they aren't addressing the right problems.

Today the two political parties differ somewhat in regard to means, but neither disputes that the ultimate goal of national policy is to make the big gauge—the gross domestic product—climb steadily upward. Neither questions that a rising GDP will wash away the nation's ills: if Americans feel unsettled despite a rising GDP, then clearly even more growth is needed.

This was clear in the months after the election, as the media continued to report economy up, people down stories that never quite managed to get to the crucial question: What is "up," anyway? In July, *Business Week* ran a cover story called "The Wage Squeeze" that got much closer than most. The article showed remarkable skepticism regarding the conventional wisdom. But the magazine's editorial writers retreated quickly. Why aren't workers doing better even as corporate profits and "the economy" are up? "America just may not be growing fast enough," they said.

Furthermore, the GDP and its various proxies—rates of growth, expansion, recovery—have become the very language of the nation's economic reportage and debate. We literally cannot think about economics without them. Yet these terms have increasingly become a barricade of abstraction that separates us from economic reality. They tell us next to nothing about what is actually going on.

The GDP is simply a gross measure of market activity, of money changing hands. It makes no distinction whatsoever between the desirable and the undesirable, or costs and gain. On top of that, it looks only at the portion of reality that economists choose to acknowledge—the part involved in monetary transactions. The crucial economic functions performed in the household and volunteer sectors go entirely unreckoned. As a result the GDP not only masks the breakdown of the social structure and the natural habitat upon which the economy—and life itself—ultimately depend; worse, it actually portrays such breakdown as economic gain.

Yet our politicians, media, and economic commentators dutifully continue to trumpet the GDP figures as information of great portent. There have been questions regarding the accuracy of the numbers that compose the GDP, and some occasional tinkering at the edges. But there has been barely a stirring of curiosity regarding the premise that underlies its gross statistical summation. Whether from sincere conviction or from entrenched professional and financial interests, politicians, economists, and the rest have not been eager to see it changed.

There is an urgent need for new indicators of progress, geared to the economy that actually exists. We are members of Redefining Progress, a new organization whose purpose is to stimulate broad public debate over the nature of economic progress and the best means of attaining it. Accordingly, we have developed a new indicator ourselves, to show both

that it can be done and what such an indicator would look like. This new scorecard invites a thorough rethinking of economic policy and its underlying premises. It suggests strongly that it is not the voters who are out of touch with reality.

A BRIEF HISTORY OF ECONOMIC (MIS)MEASUREMENT

THE GDP has been the touchstone of economic policy for so long that most Americans probably regard it as a kind of universal standard. (In 1991 the government switched from the old GNP to the GDP, for reasons we will discuss later.) Actually the GDP is just an artifact of history, a relic of another era. It grew out of the challenges of the Depression and the Second World War, when the nation faced economic realities very different from today's. Through history economic measurement has grown out of the beliefs and circumstances of the era. As Western economies went from agriculture to manufacturing to finance and services, modes of measurement generally evolved accordingly. But during this century, and especially since the war, the evolutionary process has slowed to a crawl. The market economy has continued to change radically. In particular it has penetrated deeper and deeper into the realms of family, community, and natural habitat that once seemed beyond its reach. But even as this change has accelerated, the way we measure economic health and progress has been frozen in place.

The first estimates of national accounts in the Western world were the work of one Thomas Petty, in England in 1665. Petty's scope was fairly broad; he was trying to ascertain the taxable capacity of the nation. In France, however, a narrower focus emerged. The prevailing economic theory was that of the Physiocrats, who maintained that agriculture was the true source of a nation's wealth. Not surprisingly, their economic measurement focused on agricultural production. There was a great diversity of viewpoint, however, even in France. In England, a more industrial country, Adam Smith articulated a broader theory of national wealth that included the whole swath of manufactures as well.

But one of many important points overlooked by his ardent followers is that Smith excluded what we today call the entertainment and service economies, including government and lawyers. Such functions might be useful or not, he said. But all are ultimately "unproductive of any value," because they don't give rise to a tangible product. That view was certainly debatable. But Smith was asking a crucial question—one that has pretty much disappeared from economic thought. Is there a difference between mere monetary transactions and a genuine addition to a nation's well-being?

By the end of the nineteenth century England's economic center of gravity had shifted significantly from manufacturing to trade and finance. In this new economy Smith's views on national wealth began to pinch. Alfred Marshall, who articulated what is now called neoclassical economics, declared that utility, rather than tangibility, was the true standard of production and wealth. Lawyers' fees, commissions, all the paper shuffling of an abstracted commercial economy, were essentially no different from sacks of potatoes or carloads of iron. The economic significance of a thing lay not in its nature but simply in its market price.

This yoking of national accounting to the lowest common denominator of price was to have large implications. It meant that every item of commerce was assumed to add to the national well-being merely by the fact—and to the extent—that it was produced and bought. At the same time, it meant that only transactions involving money could count in the national reckoning. This left out two large realms: the functions of family and community on the one hand, and the natural habitat on the other. Both are crucial to economic well-being. But because the services they perform are outside the price system, they have been invisible in our national accounting.

Long ago this omission was understandable. In Adam Smith's day the portion of life called "the market" occupied a very small part of physical and social space. The habitat seemed to have an infinite supply of resources, and an infinite capacity to absorb such wastes as the industry of the day might dump. The social structure seemed so firmly anchored in history that there was little thought that a growing market could set it adrift.

During this century, however, those assumptions have become increasingly untenable. It is not accidental that both the habitat and the social structure have suffered severe erosion in recent decades; these are precisely the realms that eighteenth- and nineteenth-century assumptions precluded from the reckoning of national well-being—in capitalist and socialist economies alike. This erosion has been mainly invisible in terms of economic policy because our index of progress ignores it; as a result, the nation's policies have made it worse.

To understand how the national accounts became trapped in the assumptions of a bygone era, it is useful to study the era in which the current form of economic accounting was wrought.

In 1931 a group of government and private experts were summoned to a congressional hearing to answer basic questions about the economy. It turned out they couldn't: the most recent data were for 1929, and they were rudimentary at that. In 1932, the last year of the Hoover Administration, the Senate asked the Commerce Department to prepare comprehensive estimates of the national income. Soon after, the department set a young economist by the name of Simon Kuznets to the task of developing a uniform set of national accounts. These became the prototype for what we now call the GDP.

As the thirties wore on, a new kind of economic-policy thinking started to take hold among some New Dealers. In

their view the role of the federal government was not to coordinate industry or to prevent industrial concentrations, as the New Deal had initially done. Rather, the government should serve as a kind of financial carburetor to keep a rich mixture of spending power going into the engine, through deficits if necessary.

This theory is generally attributed to John Maynard Keynes, of course, but numerous New Dealers had earlier approximated it in an instinctive and practical way. Since Keynesian management worked through flows of money rather than through bureaucratized programs, the new national accounts were essential to it. The Nobel Prize–winner Robert Solow, of MIT, has called Kuznets's work the "anatomy" for Keynes's "physiology."

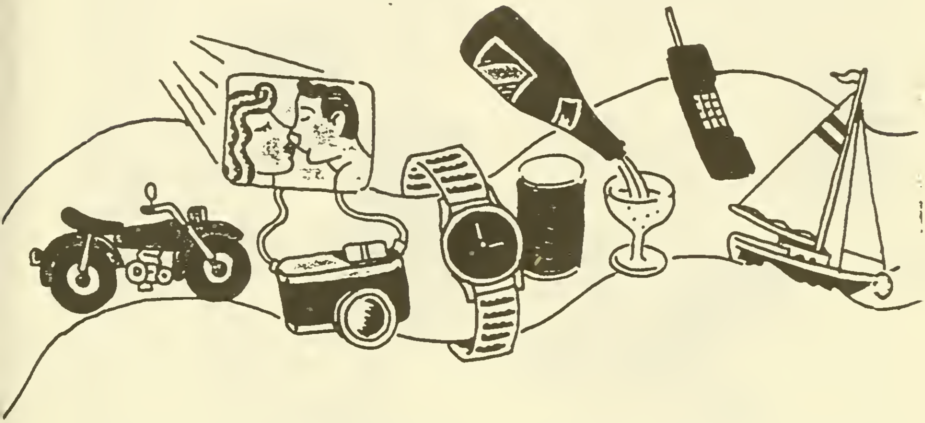
The two formally came together during the Second World War, and in the process the GNP became the primary scorecard for the nation's economic policy. The degree to which the GNP evolved as a war-planning tool is hard to exaggerate. Keynes himself played a central role in Britain's Treasury during both world wars. At the start of the second he co-authored a famous paper called "The National Income and Expenditure of the United Kingdom, and How to Pay for the War," which provided much conceptual groundwork for the GDP of today.

In the United States the Manhattan Project got much more glory. But as a technical achievement the development of the GNP accounts was no less important. The accounts enabled the nation to locate unused capacity, and to exceed by far the production levels that conventional opinion thought possible. To their great surprise, American investigators learned after the war that Hitler had set much lower production targets, partly for lack of sophisticated national accounts.

Having helped win the war, the Keynesians were giddy with confidence. The specter of the Depression still haunted the United States; but these economists thought they had found the keys to the economic kingdom. With proper fiscal management and detailed knowledge of the GNP, they could master the dreaded "business cycle" and ensure prosperity indefinitely. When John Kenneth Galbraith joined the staff of *Fortune* magazine, his first project was to prepare a blueprint for America's transition to a postwar economy. The article

was based on projections from the GNP accounts. "One good reason for expecting prosperity after the war is the fact that we can lay down its specifications," the article said. "For this we can thank a little-observed but spectacular improvement in the statistical measures of the current output of the U.S. plant."

The Employment Act of 1946 turned the GNP and the theory it embodied into official policy. It established a Council of Economic Advisers as "the high priests of economic management," as Allan J. Lichtman, a professor of history at the American University, has recently put it, and the GNP as



their catechism. The production frenzy that had pulled the nation out of the Depression and through the war was now the model for the peace as well.

These developments set the course for economic policy and reportage for the next fifty years. The ironies have been many. If it is odd that liberal Democrats would turn the principles of a war economy into the permanent template for government, it is no less so that Republicans would latch fervently onto a measure of well-being that was basically a tool of central government planning.

There have been a number of consequences that few saw clearly at the time. One was that economists became the ultimate authorities on American public policy. Before the war, economists were rarely quoted in news stories except in some official capacity. Now their opinions were sought and cited as canonical truth. Moreover, as the party that nurtured these economists, the Democrats became adherents of technocratic top-down management that purported to act for the people, even if in ways beyond their ken.

But the biggest change was in who "the people" now were. Because the Keynesian approach saw consumption as the drive train of prosperity, Washington collectively looked at the public in those terms as well. They were no longer primarily farmers, workers, businesspeople—that is, producers. Rather, they were *consumers*, whose spending was a solemn national duty for the purpose of warding off the return of the dreaded Depression. Our young men had marched off to war; now Americans were marching off to the malls that eventually covered the land.

In this atmosphere the GNP, the measure and means of policy, rapidly became an end of policy in itself. The nation's social cohesion and natural habitat, which the GNP excluded, were taken for granted. Each week the host of *General Electric Theater*, Ronald Reagan, declared to the nation that "progress is our most important product." Products were progress, and therefore the GNP was progress too.

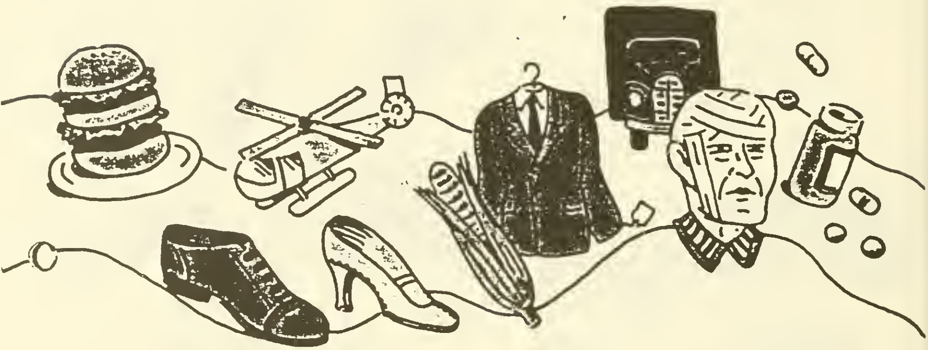
THE GDP TODAY: HOW DOWN BECOMES UP

If the chief of your local police department were to announce today that "activity" on the city streets had increased by 15 percent, people would not be impressed, reporters least of all. They would demand specifics. Exactly *what* increased? Tree planting or burglaries? Volunteerism or muggings? Car wrecks or neighborly acts of kindness?

The mere quantity of activity, taken alone, says virtually nothing about whether life on the streets is getting better or

worse. The economy is the same way. "Less" or "more" means very little unless you know *of what*. Yet somehow the GDP manages to induce a kind of collective stupor in which such basic questions rarely get asked.

By itself the GDP tells very little. Simply a measure of total output (the dollar value of finished goods and services), it assumes that everything produced is by definition "goods." It does not distinguish between costs and benefits, between productive and destructive activities, or between sustainable and unsustainable ones. The nation's central measure of well-being works like a calculating machine that adds but cannot subtract. It treats everything that happens in the market as a gain for humanity, while ignoring everything that happens outside the realm of monetized exchange, regardless of the importance to well-being.



By the curious standard of the GDP, the nation's economic hero is a terminal cancer patient who is going through a costly divorce. The happiest event is an earthquake or a hurricane. The most desirable habitat is a multibillion-dollar Superfund site. All these add to the GDP, because they cause money to change hands. It is as if a business kept a balance sheet by merely adding up all "transactions," without distinguishing between income and expenses, or between assets and liabilities.

The perversity of the GDP affects virtually all parts of society. In 1993 William J. Bennett, who had been the Secretary of Education in the Reagan Administration, produced a study of social decline. He called it "The Index of Leading Cultural Indicators," a deliberate counterpoint to the Commerce Department's similarly named regular economic report. His objective was to detail the social erosion that has continued even as the nation's economic indicators have gone up.

The strange fact that jumps out from Bennett's grim inventory of crime, divorce, mass-media addiction, and the rest is that much of it actually adds to the GDP. Growth can be social decline by another name. Divorce, for example, adds a small fortune in lawyers' bills, the need for second households, transportation and counseling for kids, and so on. Divorce lawyers alone take in probably several billion dollars a year, and possibly a good deal more. Divorce also provides a major boost for the real-estate industry. "Unfortunately, divorce is a big part of our business. It means one [home] to sell and sometimes two to buy," a realtor in suburban Chicago told the *Chicago Tribune*. Similarly, crime has given rise to a burgeoning crime-prevention and security industry with revenues of more than $65 billion a year. The car-locking device called The Club adds some $100 million a year to the GDP all by itself, without counting knock-offs. Even a gruesome event like the Oklahoma City bombing becomes an economic uptick by the strange reckonings of the GDP. "Analysts expect the share prices [of firms making anti-crime equipment] to gain during the next several months," *The Wall Street Journal* reported a short time after the bombing, "as safety concerns translate into more contracts."

Bennett cited the chilling statistics that teenagers spend on average some three hours a day watching television, and about five minutes a day alone with their fathers. Yet when kids are talking with their parents, they aren't adding to the

GDP. In contrast, MTV helps turn them into ardent, GDP-enhancing consumers. Even those unwed teenage mothers are bringing new little consumers into the world (where they will quickly join the "kiddie market" and after that the "teen market," which together influence more than $200 billion in GDP). So while social conservatives like Bennett are rightly deploring the nation's social decline, their free-marketeer counterparts are looking at the same phenomena through the lens of the GDP and breaking out the champagne.

Something similar happens with the natural habitat. The more the nation depletes its natural resources, the more the GDP increases. This violates basic accounting principles, in that it portrays the depletion of capital as current income. No businessperson would make such a fundamental error. When a small oil company drains an oil well in Texas, it gets a generous depletion allowance on its taxes, in recognition of the loss. Yet that very same drainage shows up as a gain to the nation in the GDP. When the United States fishes its cod populations down to remnants, this appears on the national books as an economic boom—until the fisheries collapse. As the former World Bank economist Herman Daly puts it, the current national-accounting system treats the earth as a business in liquidation.

Add pollution to the balance sheet and we appear to be doing even better. In fact, pollution shows up twice as a gain: once when the chemical factory, say, produces it as a by-product, and again when the nation spends billions of dollars to clean up the toxic Superfund site that results. Furthermore, the extra costs that come as a consequence of that environmental depletion and degradation—such as medical bills arising from dirty air—also show up as growth in the GDP.

This kind of accounting feeds the notion that conserving resources and protecting the natural habitat must come at the expense of the economy, because the result can be a lower GDP. That is a lot like saying that a reserve for capital depreciation must come at the expense of the business. On the con-

trary, a capital reserve is essential to ensure the future of the business. To ignore that is to confuse mere borrowing from the future with actual profit. Resource conservation works the same way, but the perverse accounting of the GDP hides this basic fact.

No less important is the way the GDP ignores the contribution of the social realm—that is, the economic role of households and communities. This is where much of the nation's most important work gets done, from caring for children and older people to volunteer work in its many forms. It is the nation's social glue. Yet because no money changes hands in this realm, it is invisible to conventional economics. The GDP doesn't count it at all—which means that the more our families and communities decline and a monetized service sector takes their place, the more the GDP goes up and the economic pundits cheer.

Parenting becomes child care, visits on the porch become psychiatry and VCRs, the watchful eyes of neighbors become alarm systems and police officers, the kitchen table becomes McDonald's—up and down the line, the things people used to do for and with one another turn into things they have to buy. Day care adds more than $4 billion to the GDP; VCRs and kindred entertainment gear add almost $60 billion. Politicians generally see this decay through a well-worn ideological lens: conservatives root for the market, liberals for the government. But in fact these two "sectors" are, in this respect at least, merely different sides of the same coin: both government and the private market grow by cannibalizing the family and community realms that ultimately nurture and sustain us.

These are just the more obvious problems. There are others, no less severe. The GDP totally ignores the distribution of income, for example, so that enormous gains at the top—as were made during the 1980s—appear as new bounty for all. It makes no distinction between the person in the secure high-tech job and the "downsized" white-collar worker who has to work two jobs at lower pay. The GDP treats leisure time and time with family the way it treats air and water: as having no value at all. When the need for a second job cuts the time available for family or community, the GDP records this loss as an economic gain.

Then there's the question of addictive consumption. Free-market fundamentalists are inclined to attack critics of the GDP as "elitists." People buy things because they want them, they say, and who knows better than the people themselves what adds to well-being? It makes a good one-liner. But is the truth really so simple? Some 40 percent of the nation's drinking exceeds the level of "moderation," defined as two drinks a day. Credit-card abuse has become so pervasive that local chapters of Debtors Anonymous hold forty-five meetings a week in the San Francisco Bay area alone. Close to 50 percent of Americans consider themselves overweight. When one considers the $32 billion diet industry, the GDP becomes truly bizarre. It counts the food that people wish they didn't eat, and then the billions they spend to lose the added pounds that result. The coronary-bypass patient becomes almost a metaphor for the nation's measure of progress: shovel in the fat, pay the consequences, add the two together, and the economy grows some more.

So, too, the O. J. Simpson trial. When *The Wall Street Journal* added up the Simpson legal team ($20,000 a day), network-news expenses, O. J. statuettes, and the rest, it got a total of about $200 million in new GDP, for which politicians will be taking credit in 1996. "GDP OF O.J. TRIAL OUTRUNS THE TOTAL OF, SAY, GRENADA," the *Journal*'s headline writer proclaimed. One begins to understand why politicians prefer to talk about growth rather than what it actually consists of, and why Prozac alone adds more than $1.2 billion to the GDP, as people try to feel a little better amid all this progress.

THE POLITICS OF PERMANENCE

SIMON Kuznets had deep reservations about the national accounts he helped to create. In his very first report to Congress, in 1934, he tried to warn the nation of the limitations of the new system. "The welfare of a nation," the report concluded, can "scarcely be inferred from a measurement of national income as defined above."

But the GNP proceeded to acquire totemic stature, and Kuznets's concerns grew deeper. He rejected the a priori conceptual schemes that govern most economic thought. As an economy grows, he said, the concept of what it includes must grow as well. Economists must seek to measure more and different things. By 1962 Kuznets was writing in *The New Republic* that the national accounting needed to be fundamentally rethought: "Distinctions must be kept in mind between quantity and quality of growth, between its costs and return, and between the short and the long run," he wrote. "Goals for 'more' growth should specify more growth *of what* and *for what*" (emphasis added).

To most of us, that would seem to be only common sense. If the government is going to promote something, surely the voters should know what that something is. But in the view of most economists, Kuznets was proposing a pipe bomb in the basement. Once you start asking "what" as well as "how much"—that is, about quality instead of just quantity—the premise of the national accounts as an indicator of progress begins to disintegrate, and along with it much of the conventional economic reasoning on which those accounts are based.

Unsurprisingly, the profession did not seize eagerly upon Kuznets's views. Though he won a Nobel Prize in 1971, many economists dismissed him as a kind of glorified statistician. Most are aware of at least some of the basic shortcomings of the GDP. But rather than face those shortcomings squarely, they have either shrugged their shoulders or sought to minimize the implications for their underlying models. In his ubiquitous economics text Paul Samuelson and his co-au-

thor William Nordhaus devote a few pages to possible revisions to the GDP to reflect environmental and other concerns. But this is more in the spirit of a technical adjustment than a questioning of the underlying premise.

The effects of the GDP fixation can be seen perhaps most vividly in what are called "developing nations" (a term that is itself defined mainly in terms of GDP)—specifically in the policies of the World Bank, which is a kind of development czar for the nations of the South. Decades ago Kuznets tried to point out the absurdity of using such a measure to assess the economies of less-developed nations, where much production takes place in the household economy and is therefore beyond the ken of the GNP. A development strategy based on raising the GNP might undermine this household economy and therefore diminish the well-being of the nation's people, while devastating the habitat to boot.

In 1989 Barber Conable, then the president of the World Bank, acknowledged the problem with respect to environmental issues. "Current calculations ignore the degradation of the natural-resource base and view the sales of nonrenewable resources entirely as income," he wrote. "A better way must be found." Yet on the floors beneath him the bank's economists continued churning out loan strategies aimed at boosting GDP. One recent World Bank publication reaffirmed it as the "main criterion for classifying economies."

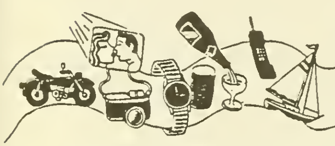
And a wrongheaded one. In a groundbreaking study of Indonesia in 1989, the World Resources Institute, of Washington, D.C., explored the implications for natural resources. Since the 1970s Indonesia had been a success story for the conventional development school, achieving an exceptional growth rate of seven percent a year. But such an amphetamine pace cannot be sustained forever. Indonesia is selling off precious nonrenewable mineral wealth. Clear-cutting its forests and exhausting its topsoil with intensive farming, it is in effect robbing the future to finance the current boom. After adding in these and other factors, the institute found that the country's real, sustainable growth rate was only about half the official rate. And that wasn't counting the broader spectrum of environmental and social costs, which would have brought the growth rate down even more.

Here was another warning for those disposed to heed it. Yet the international development establishment did nothing of the sort. In fact, what is being measured has grown more partisan than ever. Specifically, in 1991 the GNP was turned into the GDP—a quiet change that had very large implications.

Under the old measure, the gross national product, the earnings of a multinational firm were attributed to the country where the firm was owned—and where the profits would eventually return. Under the gross domestic product, however, the profits are attributed to the country where the factory or mine is located, even though they won't stay there. This accounting shift has turned many struggling nations into statistical boomtowns, while aiding the push for a global economy. Conveniently, it has hidden a basic fact: the nations of the North are walking off with the South's resources, and calling it a gain for the South.

The more basic defects of the GDP have not gone unnoticed among the nations of the world. In France a parliamentary report has called for new indicators of progress; the Treasury of Australia has done so as well. Both the UN and the European Parliament have taken up the issue, and there are ripples even at the World Bank.

But in the United States change will not come easily. The quarterly release of the GDP figures has become a Wall Street ritual and metronome for the national media, setting the tempo and story line for economic reportage. For the media in particular, the GDP serves deep institutional cravings, combining the appearance of empirical certitude and expert authority with a ready-made story line. It also serves the industries that thrive on the kind of policies it reinforces: those inclined to deplete and pollute are especially pleased with an accounting system that portrays these acts as economic



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progress. This came to light clearly last year when the Clinton Administration proposed, sensibly, that resource depletion be subtracted from GDP (albeit only in a footnote) instead of added to it.

The idea had been kicking around the Commerce Department for years, and the Administration's actual proposal was modest in the extreme. Still, at a House Appropriations Committee hearing in April of 1994 two representatives from coal states pounced on the department staff. After a series of jabberwocky exchanges that illustrated why members of Congress usually leave technical issues to their staffs, Congressman Alan Mollohan, of West Virginia, finally got to the heart of the matter. If the national accounts were to include the depletion of coal reserves and the effects of air pollution (which would be added eventually), he said, "somebody is going to say . . . that the coal industry isn't contributing anything to the country." Better to keep depletion and pollution hidden under the accounting rug called "growth." The committee demanded an expensive outside review, effectively delaying the project. In the Republican Congress its fate is by no means assured.

A GENUINE PROGRESS INDICATOR

ECONOMISTS have couched their resistance to new indicators mainly in philosophical terms. A measure of national progress must be scientific and value-free, they say. Any attempt to assess how the economy actually affects people would involve too many assumptions and imputations, too many value judgments regarding what to include. Better to stay on the supposed terra firma of the GDP, which for all its faults has acquired an aura of hardheaded empirical science.

Aura notwithstanding, the current GDP is far from value-free. To leave social and environmental costs out of the economic reckoning does not avoid value judgments. On the contrary, it makes the enormous value judgment that such things as family breakdown and crime, the destruction of farmland and entire species, underemployment and the loss of free time, count for nothing in the economic balance. The fact is, the GDP already does put an arbitrary value on such factors—a big zero.

Conventional economic thinking follows a simple premise in this regard: As Paul Samuelson puts it in his textbook, "economics focuses on concepts that can actually be measured." If something is hard to count, in other words, then it doesn't count. Of course, there will never be a way to assign an exact dollar value to our family and community life, our oceans and open spaces. This doesn't mean they don't have value. It means only that we don't have a way to register their value in a form comparable to market prices. Given that, the challenge is simply to start to develop values that are *more reasonable than zero*; it is to stop ignoring totally that which is crucial to the nation's economic and social health. An approximation of social and habitat costs would be less distorting and perverse than the GDP is now; a conservative estimate of, say, the costs of family breakdown and crime would produce a more accurate picture of economic progress than does ignoring such costs entirely.

We have a rough sketch of such a picture. On a limited budget, using data that the federal government and other institutions already collect, we have developed estimates for the kinds of factors that the economic establishment ignores. The result is a new index that gets much closer—not all the way, but closer—to the economy that people experience. We call it the "genuine progress indicator" (GPI), and it provides substance to the gap between the economy limned by the commentators and the one that has brought increasing apprehension and pain to so many others. It also begins to suggest the kinds of measurements that the federal government, with its enormous statistical resources, could construct.

The GPI includes more than twenty aspects of our economic lives which the GDP ignores. We based this list on available data and on common sense. A family does not count every dollar spent as a step forward. Rather, it tries to sort out the different kinds of expenditures—and that's basically what we did with the national accounts. We started with the same consumption data that the GDP is based on, but revised them in a number of ways. We adjusted for some factors (such as income distribution), added certain others (such as the value of housework and community work), and subtracted yet others (such as pollution costs and the like). The result is a balance sheet for the nation that starts to distinguish between the costs and benefits of "growth."

Here are some of the factors we included:

The household and volunteer economy. Much of the nation's most important work—and the work that affects our well-being most directly—gets done in family and community settings. Taking care of children and the elderly, cleaning and repairing, contributing to neighborhood groups—all of these are totally ignored in the GDP when no money changes hands. To overcome this problem, we included, among other things, the value of household work figured at the approximate rate a family would have to pay someone else to do it.

Crime. The GDP counts as progress the money people spend deterring crime and repairing the damage it causes. However, most people would probably count those costs as necessary defenses against social decline, and that's how the GPI counts them too. We included hospital bills and property losses arising from crime and the locks and electronic devices that people buy to prevent it.

Other defensive expenditures. Crime-related costs are just one kind of expenditure that seeks to repair past or present damage, as opposed to making people better off. We also incorporated the money spent on repairs after auto accidents and what households pay for water filters, air-purification

equipment, and the like to defend against the degradation of their physical environment.

The distribution of income. A rising tide of GDP doesn't necessarily lift all boats—not if the growth of income is mainly at the top. It was in the 1980s: the top one percent of households enjoyed a growth in income of more than 60 percent, while the bottom 40 percent of households saw their incomes drop. To take account of this uneven tide, we adjusted the GPI for the extent to which the whole population actually shared in any increase.

Resource depletion and degradation of the habitat. As the nation uses up oil and other minerals, this should appear as a cost on the national accounts, just as it does on the books of a private business; yet the GDP treats it as a gain. We reversed that in the GPI. Similarly, the pollution of our air and water represents the using up of nature's capacity to absorb humanity's waste. Therefore we included, among other things, the damage to human health, agriculture, and buildings from air and water pollution, along with such recreational losses as beaches fouled by sewage or medical debris.

Loss of leisure. If people have to work two jobs or longer hours just to stay even, then they aren't really staying even. They are falling behind, losing time to spend with their families, to further their education, or whatever. The GDP assumes that such time is worth nothing. We included it at an average wage rate.

To include such factors is to begin to construct a picture of the economy that most Americans experience. It clarifies greatly the "paradox" that permeated the reportage during last year's congressional campaigns. The GDP would tell us that life has gotten progressively better since the early 1950s—that young adults today are entering a better economic world than their parents did. GDP per American has more than doubled over that time. The GPI shows a very different picture: an upward curve from the early fifties until about 1970, but a gradual decline of roughly 45 percent since then. This strongly suggests that the costs of increased economic activity—at least the kind we are locked into now—have begun to outweigh the benefits, resulting in growth that is actually uneconomic.

Specifically, the GPI reveals that much of what we now call growth or GDP is really just one of three things in disguise: fixing blunders and social decay from the past, borrowing resources from the future, or shifting functions from the traditional realm of household and community to the realm of the monetized economy.

Many readers might think of additions to the list of factors that the GPI ought to include—thus corroborating both the underlying concept and the conservative nature of our calculations. We left out, for example, the phenomenon of addictive consumption, which is spending that consumers themselves say they wish they didn't do. We also left out the destruction of species, since there is not a satisfactory way to reckon such loss in economic terms.

The GPI has been several years in the making, and we will continue to refine it. But already it appears to have touched a nerve in the economics profession and beyond. More than 400 economists and a growing number of opinion leaders, including Robert Eisner, the former president of the American Economic Association, and Alvin Toffler, Newt Gingrich's favorite futurist, have endorsed it as an important step toward the new kinds of indicators that are urgently needed. Research institutes in Germany and the United Kingdom have sought to replicate it for their countries. Economic measurement is due for a radical change, and we hope that the GPI will speed up the process. But measurement is a means, not an end. The more important question is how an honest set of economic books would change the nation's economic debate and force our leaders out of their Potemkin village.

FROM SCORECARDS TO POLICIES

IMAGINE Peter Jennings on the network news tonight reciting the latest Commerce Department figures with his polished gravity. Instead of the GDP, however, he is reporting something more like the GPI. The nation's output increased, he says, but parents worked longer hours and so had less time with their kids. Consumer spending was "up sharply," but much of the difference went for increased medical costs and repairing the rubble left by hurricanes and floods. Utility receipts were up, but resources declined, meaning that part of today's prosperity was taken from our grandchildren. And so on down the line.

Reports of that kind would have a radical effect. They would break through the hermetic economy portrayed by economists and Wall Street analysts which dominates the news today—the abstractions that serve as a conceptual phalanx against reality. Suddenly reporters and politicians alike would have to confront the economy that people actually experience. There would be some genuine accountability in Washington, a better sense of cause and effect between what Congress does and what happens in our lives. New indicators would blast away the obfuscatory polemics of growth—and the devious politics that goes along with it. Politicians could no longer get away with glib assurances that the nation can grow its way out of family breakdown and environmental decay, inequity and debt, when in many cases the nation has been growing its way into them.

Such assurances have become a kind of political perpetual-motion machine. Newt Gingrich rhapsodizes about the entertainment economy and the 500 cable channels it will bring to the American living room. (When Gingrich and like-minded politicians extol "growth," entertainment is one of the things they are talking about: since 1991 it grew twice as fast as consumer spending generally.) But when these channels flood the family living room with sex and violence, and kids spend more time watching TV than they do with their parents or

their homework, he blames "McGovernik liberals" for the breakdown in traditional family values. At the same time, he's only too happy to count the new tax revenues that arise from that family breakdown toward balancing the federal budget.

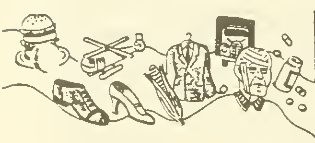
Honest accounting would blow the whistle on these political games. It would also bring a new clarity and rigor to any number of policy debates—those over trade agreements being a prime example. In the recent past these debates have been framed largely in terms of the GDP. The General Agreement on Tariffs and Trade means "percentage points . . . of U.S. GDP growth," exclaimed Bill Frenzel, a former congressman from Minnesota and a congressional representative to GATT negotiations. "It means trillions of dollars in increased world trade." This kind of talk was typical. In fact the increase means very little—only that more things will pass back and forth between nations. Will families and communities suffer continuing disruption? Will the increased traffic back and forth simply burn up more energy, the price of which is kept artificially low by tax subsidies and the like? Will America lose a measure of control over decisions that affect the lives of its own citizens?

There were efforts to raise such issues in the trade debates. But the polemical playing field was tilted sharply against them by the GDP. The result was a perpetuation of free-trade dogma that is based on the economy of 200 years ago. Better accounting would not in itself dictate a different conclusion. But at least it would level the field, and include many factors that now get left out. It would, for example, reflect some of the numerous benefits of local production that don't show up in the GDP—social stability, job security, energy savings, and the like. Free-trade dogma dismisses such thoughts as primitive and benighted.

Better indicators would also strengthen the role of family and community values in our policy debates. Rarely does anyone point out how the market itself can undermine family values in the name of growth. When regional shopping centers replace traditional Main Streets, the matrix of community activity is significantly undermined as well. Similarly, when mass media replace the storytelling of parents and grandparents, the GDP goes up while the role of families declines.

If factory jobs migrate to low-wage nations, it means cheaper products and more efficiency. But it also means severe family disruption, and the decline of the informal safety net of churches and union halls that once flourished in factory towns and helped families in need. The government obscures the impact of such policies by in effect keeping two sets of books—a visible one for the market and an invisible one for everything else. New indicators would bring the two together, and better policy just might result.

The effect would perhaps be especially direct on tax policy. The current tax system is deeply perverse, but not for the reasons that economists generally cite. Purveyors of conventional wisdom say that the tax system retards growth, by which they mean GDP. But this makes no distinction at all between muscle and bloat. They want capital-gains tax breaks, but for what? Pop art? Overseas investment funds? They urge taxes on consumption. But what kinds do they mean? Work shoes as well as Guccis? Recycled paper along with that made from ancient forests?



The more basic defects of the GDP have not gone unnoticed in other nations. In France a parliamentary report has called for new indicators of progress; the Treasury of Australia has done so as well. But in the United States change will not come easily. The quarterly release of the GDP figures has become a Wall Street ritual. It sets the tempo and story line for economic reportage. The GDP serves deep institutional cravings.

Meanwhile, the left argues for "progressive" taxes based entirely on income, as if income and the activities that produce it were inherently worthy of censure, regardless of what those activities are. Better accounting would define the issue along an entirely different spectrum.

For example, the current system taxes heavily that which should be encouraged—enterprise and human labor. Meanwhile, it taxes lightly or even subsidizes the use of the natural resources that humanity needs to husband and conserve. Employers pay a heavy fine, in the form of Social Security taxes, workers' compensation, and the rest, when they hire somebody. But they get big write-offs when they help to drain the world's natural resources. New accounting would

expose this perversity, and point toward a new tax system that defied the stereotyped categories of left and right.

To put it simply, the nation would cut—or if possible eliminate—taxes on work and enterprise and replace them with increased taxes on the use of natural resources. Such a system would diminish the need for environmental regulation, by building a semblance of environmental accounting right into the price system. Prices would include environmental and social costs. This approach would also be a spur to enterprise and employment. With reduced income taxes, the entire economy would become a kind of enterprise zone, and the nation's entrepreneurial energies would be deployed much more toward solving environmental and social problems than toward creating them. Moreover, by doing away with the corporate income tax, we could get rid of the whole loophole culture that corrupts the nation's politics and is a primary source of corporate subsidy and waste.

Closely related is the issue of cost-benefit analysis, which was one of the hot topics in Washington this year. Republicans argue, sensibly, that environmental and other regulations should bring benefits commensurate with the costs involved. But that just begs the crucial question: What goes into the accounting? If the GDP defines the framework, then cost-benefit analysis becomes a made-in-heaven deal for polluters and those who cause social disruption. If nothing counts other than what is conventionally counted, then tangible increases in production will win out over the less easily quantified—but no less real—harm to the natural and social spheres. To broaden the reckoning, however, could produce results quite the opposite of what the current advocates of cost-benefit analysis intend.

THE NEW POLITICS OF PROGRESS

It has become almost obligatory in a context such as this to invoke the concept of a "paradigm shift," to use Thomas Kuhn's much-cited formulation, laid out in *The Structure of Scientific Revolution*. But there is a side to this that is generally overlooked—namely, the central role of generational divides. Kuhn quotes the physicist Max Planck: "A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die."

One would wish for a more ceremonious process. But no field has grown more tightly shut than economics, whose basic orthodoxies have persisted for at least a hundred years. Unless history stops cold, these, too, will eventually yield, and the time is now propitious. The generation that developed the GDP, and for which the GDP distilled an entire world view, is now mainly retired. The students and disciples of that generation are well into their middle years, rumbling along on mental capital from long ago. For the generation that is replacing them, the defining traumas were not the Depression and the Second World War but rather the material glut and environmental and social disintegration of which many in the old guard served as unwitting boosters and engineers.

To be sure, the old order does not lack acolytes. But for a growing number of economists, the conceptual tools and measurements of the neoclassical model—Keynesian twists included—are no longer adequate. These economists are demanding that their profession start to take account of the larger economy in which the market is grounded—the natural and social spheres, which they have in the past dismissed as the netherworlds of externality. In a survey in the 1980s of economists at fifty major universities two-thirds acknowledged a sense of "lost moorings" in the profession.

In recent decades this kind of critique has been associated mainly with the ecological camp. Herman Daly, Hazel Henderson, Kenneth Boulding, and other writers have pointed out that in a world of finite physical resources the possibility of endless material expansion is not something we should count on. What is new today is that a similar argument is coming from certain quarters on the right: specifically that the pursuit of GDP has been undermining traditional values and social cohesion, much as it has been destroying the natural habitat.

Americans are conditioned to see ecology and social conservatism as occupying opposite ends of the political spectrum. But that is largely an optical illusion, reinforced by an antiquated national accounting system. The fact is that adherents at both ends deplore the way the pursuit of GDP can undermine the realm of their concern. Much as this pursuit turns ancient forests into lumber and beaches into sewers, so it turns families into nodes of consumption and the living room into a marketing free-fire zone. Both camps speak from the standpoint of *values* against the moral relativism and opportunism of the market. "If you read the New Testament or the Pope's encyclical, it's no cheers for socialism and one and a half or two for capitalism," William Bennett, who was Reagan's Secretary of Education, observes. "Socialism treats people as a cog in the machine of the state; capitalism tends to treat people as commodities."

This strain of conservatism, partly rooted in traditional Christian teachings, was largely dormant during the Cold War, when the greater enemy communism predominated. But with the fall of the Soviet bloc it has reawakened, and the result has been a widening gap on the right between social conservatives and libertarian free-marketeers. This gap was easily overlooked in the Republican triumph last November, but it may well become as important as the one between the Republicans and the Democrats they replaced.

It can be seen, for example, in the diverging views of that archetypal Republican era, the Reagan eighties. Martin Anderson, who was Reagan's domestic-policy adviser, gave the rapturous libertarian view in his book *Revolution* (1988). "It was the greatest economic expansion in history," Anderson wrote. "Wealth poured from the factories of the United States, and Americans got richer and richer."

But does richer mean better—even assuming that all Americans shared in this bounty, which they didn't? For libertarians, as for many Keynesian liberals, the question isn't relevant. For social conservatives, however, it is *the* question. Bennett does not disparage the economic achievements of the Reagan years. Nor does he dispute that more family income can mean better schooling, medical care, and the like. But recently he has been calling attention to the social decay that has continued despite (and often in the name of) economic growth. "Would you rather have kids raised by rich people with lousy values, or by good people who just don't have much money?" he asks. "A lot of us would say we want the values right."

What the right calls "family values" is one arena in which the latent conflict between market and nonmarket values is coming out into the open. In a long article in *The Washington Post* last November, Edward Luttwak, of the Center for Strategic and International Studies, a conservative think tank in Washington, D.C., pointed out that much family disruption today arises from the "creative destruction" of the market that free-market economists adore. The failure to acknowledge this, Luttwak wrote, is "the blatant contradiction at the very core of what has become mainstream Republican ideology."

In an interview Luttwak argued that people need stability more than they need much of the new stuff that makes the GDP go up. Yet economists talk about stability "in entirely negative terms," he said. Conservation becomes a dirty word. One would think that conservatives would be the first to point this out; stability, after all, is what families and communities are for. But the political right is muzzled on these issues, Luttwak said, by the economic interests of its major funders. "Any conservative who wishes to conserve will not be funded."

This split has a distinct similarity to the tension that arose in the Democratic Party in the seventies between environmentalists and the growth-boosting Keynesian mainstream. It could betoken the beginning of a new politics in which the popular currents represented by social conservatives and environmentalists increasingly find common cause. Some writers have made the connection already. For example, Fred Charles Iklé, who was an undersecretary of defense in the Reagan Administration, wrote an article for the *National Review* in which he criticized the "growth utopians" of the right. "Citizens who fear for our vanishing patrimony in nature," Iklé wrote, "drink from a wellspring of emotions that nourishes the most enduring conservative convictions." (He also tweaked the magazine's right-wing readers by pointing out that economic growth almost invariably leads to bigger government.)

Just a few years ago a confluence of the environmental and social-conservative impulses would have seemed unlikely. But the political seas are changing rapidly. The coalition that came together to oppose NAFTA and GATT—environmentalists and anti-corporate populists like Ralph Nader on the one hand, and social conservatives like Pat Buchanan on the other—seemed an oddity to most pundits. But something similar happened when the Walt Disney Company proposed a new theme park near the Civil War battlefield in Manassas, Virginia. Buchanan and numerous other tradition-minded conservatives joined environmentalists in blasting the proposal. In his syndicated newspaper column Buchanan demanded, "Conservatives who worship at the altar of an endlessly rising GNP should tell us: What is it they any longer wish to conserve?"

The two camps have converged in opposing the so-called "takings" bills, which would require the taxpayers to compensate property owners for restrictions on the use of their property. The Reverend Donald E. Wildemon, the president of the American Family Association, in Tupelo, Mississippi, has called such a proposal in his state the "porn owners' relief measure," because it could restrict the ability of local governments to control such things as topless bars. Environmentalists of course worry about the implications for the protection of wetlands, open space, and the like. The two camps agree that "growth" is not an end in itself but must serve larger values that are not economic in the usual sense.

We may be witnessing the opening battles in a new kind of politics that will raise basic questions about growth—questions that defy the conventional left-right divide. Where the old politics was largely concerned with the role of government—with the relation between public and private sectors—the emerging one will be more concerned with such issues as central versus local, market culture versus family and community culture, material accretion versus quality and values. The new politics will not be anti-growth, because to be categorically against growth is as nonsensical as to be categorically for it. Rather, it will begin with Luttwak's sane observation that when your goal is simply to increase GDP, then "what you increase isn't necessarily good." It will insist that growth—and economics generally—must be a means to an end, and not an end in itself.

This is not to suggest that such a new alliance is around the corner. But although the differences between the social-conservative and environmentalist camps are still large, they are probably etched more sharply among leaders in Washington than in the nation as a whole. These groups are converging on one crucial issue—namely, the ends of economic life. In their different ways they are expressing the feeling, widespread among the public, that the pronouncements from economic experts are fundamentally out of sync with the experience of their own lives; that economics must be about more than just the production and consumption of stuff; and that we need larger goals and better ways to measure our achievements as a nation.

Of course, this instinct could play out in many ways. But at least one thing is clear: boosting the GDP is no longer a sufficient aim for a great nation, nor one that America can continue to endure.

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